YOUNG FAMILIES HOUSING ACT OF 1977

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

S. 664

TO AMEND THE NATIONAL HOUSING ACT TO PROVIDE FOR THE INSURANCE OF GRADUATED PAYMENT MORTGAGES, AND FOR OTHER PURPOSES

S. 1078

TO AMEND SECTION 245 OF THE NATIONAL HOUSING ACT TO REVISE THE EXPERIMENTAL MORTGAGE INSURANCE PROGRAM

MARCH 31 AND APRIL 1, 1977

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

YOUNG FAMILIES HOUSING ACT OF 1977

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

S. 664

TO AMEND THE NATIONAL HOUSING ACT TO PROVIDE FOR THE INSURANCE OF GRADUATED PAYMENT MORTGAGES, AND FOR OTHER PURPOSES

S. 1078

TO AMEND SECTION 245 OF THE NATIONAL HOUSING ACT TO REVISE THE EXPERIMENTAL MORTGAGE INSURANCE PROGRAM

MARCH 31 AND APRIL 1, 1977

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

88-114 O WASHINGTON : 1977

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402
Stock Number 052-070-04135-8

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WILLIAM PROXMIRE, Wisconsin, *Chairman*

JOHN SPARKMAN, Alabama
HARRISON A. WILLIAMS, JR., New Jersey
THOMAS J. McINTYRE, New Hampshire
ALAN CRANSTON, California
ADLAI E. STEVENSON, Illinois
ROBERT MORGAN, North Carolina
DONALD W. RIEGLE, JR., Michigan
PAUL S. SARBANES, Maryland

EDWARD W. BROOKE, Massachusetts
JOHN TOWER, Texas
JAKE GARN, Utah
H. JOHN HEINZ III, Pennsylvania
RICHARD G. LUGAR, Indiana
HARRISON SCHMITT, New Mexico

KENNETH A. McLEAN, *Staff Director*
JEREMIAH S. BUCKLEY, *Minority Staff Director*
ROBERT E. MALAKOFF, *Staff Director, Subcommittee on Housing and Urban Affairs*
JAMES H. SCHUYLER, *Minority Counsel, Subcommittee on Housing and Urban Affairs*
MICHAEL B. BARTON, *Special Counsel*
JOANN S. BAREFOOT, *Professional Staff Member*
THOMAS A. BROOKS, *Minority Assistant Counsel*

CONTENTS

LIST OF WITNESSES

Thursday, March 31

Friday, April 1

Witnesses Statements, Charts, Tables, and Data Submitted for the Record

CONTENTS

LIST OF WITNESSES

Thursday, March 31

Friday, April 1

Witnesses Statements, Charts, Tables, and Data Submitted for the Record

YOUNG FAMILIES HOUSING ACT OF 1977

THURSDAY, MARCH 31, 1977

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10:30 a.m., in room 5302, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Sparkman, Brooke, and Lugar.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

The committee is opening hearings this morning on S. 664, the Young Families Housing Act, the principal sponsor is Senator Brooke. This is a bill proposed by Senator Brooke and cosponsored by a number of other Senators. We are also holding hearings on S. 1078 which is proposed by the administration and introduced by myself and Senator Brooke to provide for an expanded graduated payment mortgage program for FHA.

These two bills could be thought of as the tip of an iceberg. They represent a very small component of a major movement which is stirring the housing field today—the interest in new, alternative mortgage instruments. The significance of this movement is considerable, because its impetus comes, in part, from two major trends influencing public housing policy today.

The first of these two forces is the growing concern over the so-called affordability gap in housing—the fact that escalating house prices, interest rates and operating costs such as utilities have driven the cost of home ownership beyond the reach of most American families. In a society which believes as we do in the value of home ownership to both the individual and the community at large, the fact that most people cannot afford to buy a house cannot be tolerated.

The second force behind the interest in new mortgage instruments is the compelling idea that consumers should, to the extent possible, have freedom of choice. People have differing life styles, needs, and tastes, and it makes sense to let them exercise their own judgments of what they need and want in buying and financing housing. Accordingly, it is desirable to let consumers choose alternatives to the traditional, level payment mortgage, provided that we can assure that their choice is an informed one which truly understands the benefits and drawbacks involved.

It would be inaccurate to say that these hearings or these two bills deal comprehensively with the questions of home ownership affordability or the desirability of new mortgage instruments in general. Both of these subjects reach far beyond the scope of the issue at hand. The committee has held hearings on new mortgage instruments and on variable rate mortgages in the past. We have also, of course, developed programs over many years to deal with the most significant variable in housing affordability—mortgage interest rates. We will, in the future, schedule further, much more comprehensive hearings on both subjects.

Nevertheless, today's hearings deal with an important first step in the consideration of home affordability and new mortgage instruments. That step, which is contained in both S. 664 and S. 1078, is to allow FHA to insure graduated payment mortgages in an unlimited volume. At present, FHA is insuring these GPMs up to one percent of its volume, under experimental authority contained in Section 245 of the National Housing Act, as amended in 1974.

There are potential problems with the GPM. It may be that consumers will have difficulty in understanding it, and will select it against their own interest. There are questions about what will happen when their incomes do not rise as much as expected. There are serious questions as to whether lenders will even want to offer GPMs, given the fact that they involve a lower cash flow in the early years than a standard loan. And finally, there is the significant contrasting danger that the availability of the GPM would tend to allocate loans toward young but potentially affluent suburban borrowers, and away from the moderate-income, urban families who already have such difficulty affording a home.

Despite these open questions, I think the expansion of GPMs for FHA loans is an extremely attractive idea. I commend Senator Brooke for his leadership which has been so conspicuous not only here but in many other areas, in housing and elsewhere.

Senator Brooke, I understand you have an opening statement.

OPENING STATEMENT OF SENATOR BROOKE

Senator BROOKE. Yes. Thank you, Mr. Chairman.

Mr. Chairman, since 1970 there has been a steady decline in the number of families who can afford to buy their own homes. A report just completed by the Harvard-MIT Joint Center for Urban Studies found that only 27 percent of American families could afford to buy a median priced home in 1976 compared with 46.6 percent of all families in 1970. And that same report warned us if new home prices continued to rise at their 1970–76 pace the typical new home would be selling for $78,000 in 5 years and only the highest income families would be able to afford those houses.

The families who have been most affected by this affordability problem have been young families and young single persons of moderate incomes who are trying to purchase a home for the first time.

As a Congressional Budget Office report on home ownership which was released in January of this year observed, the first-time home buyer is confronted by the full spectrum of cost increases, changes in

sale price, interest rate, property tax, hazard insurance, maintenance and repairs and heating and utilities. There is an increasing proportion of families in the 25 to 34 years old age group seeking to buy a home for the first time. They are finding that they are unable to afford the homes which their older brothers and sisters bought just a few years ago.

The two principal obstacles to home ownership for these families have been high monthly mortgage payments and increasing downpayment requirements. The Congressional Budget office study reported that the cost of a median priced new home for first time home buyers has risen almost twice as fast as their incomes and that downpayments on median priced new homes have risen almost 1⅔ times as fast as their incomes during the period 1970–75.

Over the past year, I have been working with Dr. Kenneth Rosen, professor of Economics and Public Affairs at Princeton University, on a proposal to assist these families in buying a home. I introduced the Young Families Housing Act on July 23, 1976, and, as you will recall, Mr. Chairman, 3 days of hearings on that bill were held by the Subcommittee on Housing and Urban Affairs in August of last year.

The bill introduced last year established a new FHA insured mortgage instrument, an equity adjusted mortgage, which would reduce monthly payments during the early years of a mortgage and would increase those payments proportionately during the later years.

After the hearings on the bill President Ford announced last September that FHA would initiate an experimental graduated payment mortgage program which was similar to the approach contained in my bill. The graduated payment mortgage utilizes the same principles as the equity adjusted mortgage and appears to be more acceptable to the lender and more understandable to the prospective home buyer.

The bill which I reintroduced this year, Senate 664, provides authority for FHA to make its experimental graduated payment mortgage program a permanent program. The GPM is structured to take account of the fact that a young family's income and the value of its home are likely to rise over the life of the mortgage. I believe that the GPM will give more families the opportunities to buy a home and to begin to build equity for the future.

The second provision of the bill allows the creation of a new type of tax-exempt savings account, an individual housing account. It would allow first time home buyers—and only first time home buyers would be eligible—to accumulate the equity for a downpayment on a home. This savings account which operates on a similar principle to the individual retirement account would permit a potential home buyer to deposit up to $2,500 a year to a maximum of $10,000. This amount would be deductible from income for income tax purposes and the interest income would be exempt from taxation.

Senate 664 contains one provision which was not present in last year's section providing for individual housing accounts. This would provide for recapture of a portion of the taxes foregone at capital gains rates upon sale of the home. This would be accomplished by

reducing the basis in the house at the time of sale by the amount of the downpayment which derived from the individual housing account.

Mr. Chairman, I am pleased that S. 664 has 21 cosponsors, including the very distinguished chairman of the Housing Subcommittee, the father of housing, Senator John Sparkman of Alabama, and Senators John Tower and Thomas McIntyre, John Heinz, and Richard Lugar of this Banking Committee.

I am particularly pleased that our chairman, Senator Proxmire, had decided to support the graduated payment mortgage proposal and he has introduced Senate 1078 which I cosponsored which is substantially the same as the first section of S. 664. I hope that our distinguished chairman will become convinced of the wisdom of the individual housing account portion of the bill during these 2 days of hearings.

Mr. Chairman, I believe very strongly in the need for this bill in order to restore the possibility of home ownership for millions of American families who may otherwise never have the opportunity to buy a home. Home ownership has always been the principal way in which American families acquire equity and a stake in our society. If the majority of our young families are deprived of the opportunity for home ownership, I believe that we will lose one of the most important stabilizing forces in our society. The Young Families Housing Act will not only promote that stability but also help these families achieve their dream of owning their own home.

Mr. Chairman, it is most appropriate that our first witness today is Dr. Kenneth Rosen, Professor of Economics and Public Affairs at Princeton University. I want to welcome Dr. Rosen as a witness before our committee. Dr. Rosen testified before us last year and was most helpful in explaining the dynamics of the housing market and the need for innovative proposals such as a new mortgage instrument and an individual housing account. Dr. Rosen has worked very closely with me on the concept of the Young Families Housing Act for more than a year and I want to thank him personally for his useful contributions to this committee and to the housing field.

The Chairman. Thank you, Senator Brooke.

We have a statement of Senator McIntyre which we'll insert in the record at this point as though read.

STATEMENT OF SENATOR McINTYRE

Senator McIntyre. Mr. Chairman, early passage of the Young Families Housing Act is essential and I am pleased to be a principal cosponsor of this legislation with my good friend and colleague, Senator Brooke.

The most difficult problem facing potential first time homeowners today is the ability to meet down payment requirements on home purchases. S. 664 addresses this situation by providing tax-exempt homeowner savings accounts to potential homeowners. Young couples will be particularly aided in that they would be able to put up to $2,500 a year aside for individual home purchases with a maximum $10,000.

The bill also assists home purchases by encouraging the use of a new type of mortgage instrument—a graduated payment mortgage. This

type of mortgage would make it possible for young families to make smaller monthly payments during the early years of homeownership and proportionally larger payments later. Younger families are finding it increasingly difficult to make ends meet and a graduated payment mortgage should help a young couple in the early years of marriage.

The problems of down payment requirements and the ability to meet monthly payments are the two biggest blocks to homeownership. Early passage of the "Young Families' Housing Act" is of fundamental importance if the American dream of homeownership is to remain an attainable reality.

The CHAIRMAN. I have a note from the leadership which says any Senators who have amendments to Senate Resolution 110—that's the ethics bill—please come to the floor as soon as possible. I don't think that applies to any of us, so we are all set to go.

Senator BROOKE. As important as ethics is, Mr. Chairman, I think housing is even more important at this point and I forego that opportunity.

The CHAIRMAN. I agree with you.

Senator SPARKMAN. We live closer to it.

The CHAIRMAN. We certainly do.

Dr. Rosen, we are very happy to have you with us this morning. You appeared before our committee before and I think you have a superlative statement. Go right ahead, sir.

Incidentally, I'd like to apologize to Senator Brooke. He was very anxious to have us start at 10 o'clock and as you know we had these hearings we just had to have on acting on the nominations. So I would like to have the witnesses, if they could, make their statements as concise as possible. We will print the complete statements in the record.

STATEMENT OF KENNETH T. ROSEN, PROFESSOR, PRINCETON UNIVERSITY

Dr. ROSEN. Thank you, Senator Proxmire and also thank you Senator Brooke, for the kind introduction.

What I'd like to do today is somewhat different than the usual type testimony I give. I have a number of charts and I'd like to go over them and I'm not going to read my statement at all. I'd like to show the charts and to demonstrate what I think the cause of the present housing problem is and how the graduated payment mortgage and individual housing account may help alleviate this problem.

I guess first I should say that you all realize we are in the middle of a major housing recovery at the moment. Single family starts and existing home sales are at near record levels and some people may think they don't really have a housing problem at the moment.

Despite the short term boom, however, I think the fundamental long-term outlook for housing has gotten much worse and I think that the main reason for this is that we are on the verge of a major explosion in housing prices and I will go over that in my testimony.

We have all seen the reports that have come out in the last 2 or 3 months—the Joint Center for Urban Studies report, the CBO report

which indicated that probably 30 to 40 percent of American families can now afford to purchase the median priced home. This is a sharp change from the normal situation when approximately 75 to 80 percent of family households in the prime age group could purchase a home, so we are talking about a very large reduction of families who will be able to purchase possibly over the next 10 years.

I think the major cause of this problem has really been a sharp acceleration in the housing prices. If you look at this first chart, the top portion of the chart, I show the overall rate of inflation first and you can see that's about 7.7 percent in the last 6 years (see chart on page 41). At the same time, home prices have gone up much faster than the overall inflation. New home prices have gone up 9.4 percent and existing home prices at 10.7 percent per year. What this means is a new median priced home is selling for about $47,500. The median existing home is selling for $40,000. What we have seen happen is the cost of home ownership has risen substantially relatively to the rate of inflation.

In addition to the price effect, we also have the downpayment effect and I think this is something that perhaps not enough attention has been given to. Everybody looks at housing prices and says they are rising very fast and it's a problem, but the downpayment is the major constraint that's facing young families and the average downpayment was about $11,500 on the conventional home in 1976, and what again this implies is it's very difficult for the young family with an average income to save that amount of money.

What I'd like to do now is look at the outlook for the next 10 years because when talking about policy for the housing market and this young families housing program I think the key question is what is going to happen in the next 10 years especially for young families because that's the group we're talking about, helping with this program.

If you look at the bottom portion of this chart you will see that assuming we had a 7 percent inflation rate in the overall economy, the forecast for housing prices in the next 10 years is for a major explosion in housing prices. The situation will become much worse. According to figures I have—and this is derived from an econometric model that I have built with Professor Jaffe at Princeton, the average new home in 1986 will sell close to $90,000. This is almost a doubling of the present price.

The CHAIRMAN. What year is that?

Dr. ROSEN. 1986, which is 10 years down the road.

Senator BROOKE. That's the average cost?

Dr. ROSEN. Of a median priced home. Now what that means is the rate of inflation in new home prices is about 10.7 percent a year and if the overall inflation rate is going up 7 percent a year you're developing a major gap in the affordability of a house.

At the same time—and I think this is something that again I'd like to emphasize—the downpayment requirement would become very substantial. We are talking about the downpayment that could be between $22,000 and $25,000 on a median priced home. So again you're talking about accumulating a very substantial sum of money.

Now this housing market inflation, as you can see from the chart, is forecast to be 10.7 to 10.9 percent and if you take this effect into account with the mortgage interest rate—and this is a major finding of the work I have done—is that the mortgage rate, if we have a 7 percent inflation rate over the next 10 years, we're talking about a mortgage interest rate of 10.7 average over the decade and at times going over 11 percent.

What that means is the cost of home ownership, if you take into account the house price increase plus the cost of mortgage money increase, you're talking about a cost of home ownership that's rising at about 12 percent a year. So that even if you assume that there is some increase in real income of let's say 2 or 3 percent a year, there's going to be a gap of about 3 to 3½ percent a year for households in terms of buying, being able to afford to buy a house.

Now if you switch to the next chart (see chart on page 40) you can see this price problem is going to be compounded by a major boom in household formation. As everybody is probably aware, the post-war baby boom is coming on the housing market during this next 10 years. From 1968 to 1974 we had 5.4 million households formed. These are family households that I'm talking about, and the focus on this bill is on young families and I define that as being between the ages of 25 and 40.

Of these, about 4 million were able to purchase a home. So it's about 75 to 80 percent of households in the prime age that have been able to buy homes. In the next 10 year period, we are forecasting a 31 percent increase in the number of young households who would be coming on to the market, which is a very substantial increase, it will be the biggest increase we have had in our history in terms of people coming on to the market.

Based on this projection and home ownership cost projections only about 2.8 million of these people will be able to buy a home. Normally it would be about 5.3 million. So we are talking about 2.5 million people who will not be able to buy a home which they normally would have liked to purchase. I'm still assuming there will be about 25 percent of the people who will want to rent. I'm assuming there will be no shift in that proportion. We're talking about 2.5 million families households who will be priced out of the market and will not be able to purchase a home if these price and cost projections are reliable.

Now there's one other problem associated with the housing market, especially with the effect of inflation on the housing market. This is really the problem of the standard level payment mortgage instrument and how effectively it can meet the needs of households. If we turn to the next chart (see page 42), you will see that the standard mortgage instrument has a very distorted payment stream because of the impact of inflation. The standard mortgage instrument basically is a level payment of mortgage and assuming we had no inflation the households would have to pay about $2,768 a year on a $30,000 loan. This is the amount of actual payments that a household would make. If we have a 5-percent inflation rate, you're talking about the mortgage rate being pushed up to 8½ percent. So you're talking about payments that approach $3,000 a year to amortize the same mortgage.

The payments are made constant over time and while it may work very well for the lender, and even then I'm not sure it does if the lender has not anticipated inflation. But assuming he has, it doesn't work very well for the borrower because it does not take into account the fact that the borrower can expect his income to go up roughly at the rate of inflation.

What happens is there is a major mismatch because of the mortgage instrument. As a percentage of the income the real payments decline sharply over the life of the loan. If the household put up 20 percent of his income initially for the mortgage, assuming a 5 percent inflation, he may be paying only about 3 percent of his income for that same mortgage instrument by the 25th year of the loan.

This problem is known as an inflationary gap. There's an inflation gap because if inflation causes mortgage interest rates to go up, as we expect them to, then a number of households can no longer afford the standard mortgage instrument.

What I'd like to do now is explain how the Young Families Act would try to meet the cost escalation and the downpayment problem and the mortgage instrument problem.

Basically there are two elements to the Young Families Housing Act. The first element is a graduated payment mortgage instrument and the second element is the individual housing account.

As compared to the conventional mortgage loan, a graduated mortgage payment loan provides lower monthly payments on a mortgage during the initial years of the loan and higher payments in the later years of the loan. This loan pattern attempts to offset this mismatch we have seen in the first diagram. The payment pattern allows the household to take advantage of the positive effects of inflation on increasing his money income and on increasing the property value. A number of different types of graduated payments are now being insured on an experimental basis by FHA and the amount of graduation varies from 2 percent to 7½ percent with the graduation lasting from 5 to 10 years.

I think the GPM, which is a shorthand name for the graduated payment mortgage, should be especially appealing for the Government because it provides a way of improving the ability of households to buy a home without costing the Government any direct Federal expenditures.

What is required in this bill is that the FHA insure such loans on more than an experimental basis putting it on a permanent basis, and I think we should also put a statement in this bill encouraging Federal regulatory agencies—the Federal Home Loan Bank Board, the Federal Reserve Board—to allow and encourage the granting of this type of loan. I think it's not enough to have the FHA do this sort of thing, but we have to encourage the private market to do the same sort of thing.

At the moment, FHA may account for 8 or 10 percent of the market, so you're talking about 90 percent of the market being served by the conventional mortgage instrument. So we would like to encourage the conventional market to do a similar thing. The private insurance industry has said they will insure such loans, so there should be no extra risk associated from the point of view of any S&Ls or a bank.

They can get private insurance money on these loans so there will be insurance comparable to the FHA insurance.

Now if we turn to the next chart (see page 34), I'd like to show you what the graduated payment instruments that HUD has devised will do for the household. You can see they are basically four lines here. The first line is the standard mortgage instrument. This is for a $30,000 loan amortized over 30 years and this is the standard instrument and you can see it's a level payment over time.

What the GPM payments do is they reduce the initial payments for a 5 or 10 year period with the payments then graduated up for the first 5 or 10 year period and then from that point on the payments are somewhat higher than they would be under the conventional instrument. Even under the steepest graduation plan of HUD the payments are only about $200 more from the fifth and tenth year than they would be otherwise. So you're talking about a modest increase after the fifth or tenth year but you're talking about an additional reduction that could be anywhere on the order of 28 percent for the 8½ percent—3 percent of graduation, 10 year instrument.

What that means is that if you're talking about purchasing a $40,000 home, and there's no reason that the young household has to purchase a median priced home—he probably would purchase a house that would be below the median price—the household earning only $12,000 a year could now enter the housing market as compared to somebody who previously had to earn about $16,000 a year.

So the focus of this graduated payment mortgage is reducing the initial year to year payment. I think the key thing you should think about in terms of alternative mortgage instrument is there's no reason that we should not provide the consumer with a choice. We are not saying the consumer has to take this and I think in any sort of alternative instrument you should spell out very clearly what the consumer's obligations will be over a period of time.

What we are trying to do with this instrument is provide the consumer with a choice and in no way requiring that he take this type of instrument.

I would like to suggest one change in the HUD plan and the change I would like to suggest is that HUD also consider insuring instruments that have a somewhat longer graduation period. In particular, I'd like to see them issue a 5-percent or 7½ percent 10 year graduated payment mortgage loan. In other words, have the graduation go for a 10 year period. As you can see, only the 2 or 3 percent loans are graduated over a 10 year period and there's no reason they could not do the same thing with the 5 or 7½ percent loan. That would obviously reduce the initial mortgage payments more and provide even greater opportunities for home ownership.

I'd like to move now from the graduated payment instrument to the individual housing account and I suspect that's the portion of the Young Families Housing Act that's most controversial. Basically, the individual housing account Senator Brooke has described provides for the households to be allowed to deduct up to $2,500 per year from his gross Federal income tax and be able to put this money into a segregated individual housing account. He would be allowed to accumulate up to $10,000 over the life of this account.

Also, there is a tax recapture provision but it's probably an imperfect tax recapture. You probably won't recapture more than 25, or 30, or maybe 40 percent of the tax loss. So you have to realize that you're making a tax expenditure. But what the individual housing account does which I think is very useful, and it's been tried and used in almost all the industrial countries in Western Europe and Canada, is to provide savings for housing programs. In essence you're encouraging the household to be frugal, to save his own money, and to accumulate his own equity in the unit. This is done in many of these countries is help alleviate the capital shortage that is facing the housing segment of the market. These plans are basically earmarked for housing. They know they are saving for housing and they are saving for their downpayment. Canada has a program like this and it has worked very successfully. It's been used by quite a number of young households. Germany also has a program like this. The interesting fact about the German program is that their plan was so successful that during the last credit crunch there was not a shortage of capital in the housing market.

Now just a couple points on the individual housing account. I think I would suggest several changes to make the program a little more equitable. There are two potential objections to the program one might have. The first is the program is somewhat regressive in the sense that anyone of any income bracket can use this program and those in higher income brackets would presumably have the greatest tax saving.

Now what I would like to propose what I think would make the program somewhat more acceptable is that we put an income limit on the individual housing accounts, that we possibly limit the utilization of this account to people who have incomes of less than $20,000 a year so that would make the program far less regressive and also far less costly.

However, to think that the families making $30,000 a year are going to wait and use this individual housing account is probably a mistake. The household making $30,000 a year and let's say is going to buy a $60,000 house realizes the rate of appreciation at 5 percent, he's going to make $3,000 a year in terms of capital gain and there's no way he's going to wait a year to get a tax savings of $500 or $700. It doesn't make any sense.

The second and last point I'd like to make is that it seems to make a lot of sense to look very carefully at what sort of revenue loss you're going to have. I have seen a number of estimates and I have also made an estimate. I have assumed that approximately 1 million households will participate in the first year at a cost of $625 million. The reason I assume 1 million households, is that you should not assume every household who is going to buy a home is going to participate in this program. This is just not going to be the case. Over the life of the program, I suspect that revenue loss will be somewhere in the order of $6 to $12 billion let's say over a 10-year period and this is not a small sum of money. This is clearly a large tax expenditure.

Briefly, to summarize, I think that these two elements—the graduated payment mortgage and the individual housing account—are

crucial if we're going to try to meet the goals that we have set previously providing a decent home and a suitable environment, and I think it would be very useful if Congress added a last phrase to this goal "at an affordable cost," and I thank you very much for the opportunity to present this.

The CHAIRMAN. Thank you, Dr. Rosen, for a remarkable presentation and I particularly congratulate you on your table 2 (see page 29), which I think is a devastating presentation of what happens when you have a 5 percent inflation rate and 8½ percent mortgage interest rate. What you show, as I understand it, is that while the annual nominal payment under those circumstances may be $2,098 a year each year, that because of the inflation and the rise in nominal income the real payment drops from $2,753 in the first year to $763 in the 25th year, and the percentage that the payment represents of income drops from just under 20 percent to only about 3 percent.

Now there's just a couple assumptions I'd like to question you on. In the first place, you have a rise in nominal income in the first part of the table in a noninflation world. What is that based on?

Dr. ROSEN. Basically, over the long run, household income has risen about 2 percent a year.

The CHAIRMAN. In real terms?

Dr. ROSEN. In real terms. So I put that assumption in there. It's in both portions of the table. I have assumed the household incomes will rise 2 percent a year. For young families that's probably underestimated. It will probably rise at a faster rate.

The CHAIRMAN. This is all positioned on the notion that a lot of us have come to accept—we had a very, very distinguished economist—as a matter of fact, it was Carol Greenwald who's a Ph. D. from Harvard and Banking Commissioner in Massachusetts, and I think as able a person as there is in the field, who said "we have always had inflation." We haven't always had inflation. We didn't have inflation as a way of life until 1945. We had it during wars and then the prices would drop. Supposing we do not have inflation? I think you're probably right. We probably will have something like 5 percent or maybe more, but supposing we don't have that. Then what happens? Or supposing we have deflation?

Dr. ROSEN. I'll first assume we slow down inflation let's say to 3 percent.

The CHAIRMAN. Let's assume we don't have any inflation.

Dr. ROSEN. If we had zero inflation, what would happen?

The CHAIRMAN. A lot of people would get caught in a very embarrassing position.

Dr. ROSEN. I think not. If we had zero inflation, that would happen over let's say a 5-year period—and I hate to say that sort of thing—it would be very nice to think of it, but if we had that, mortgage interest rates would plummet dramatically. People would pay off these loans and take out conventional loans at 3⅓ percent. If we had zero inflation, the mortgage interest rate would fall, but it would take some time.

The CHAIRMAN. That may very well happen, but the value of a lot of this is based on the fact that the equity in the house increases and the values increase. If you had zero inflation that wouldn't happen.

Dr. ROSEN. In the graduated payment plan?

The CHAIRMAN. Yes. It might not happen. In many cases the value of the house might drop.

Dr. ROSEN. You're talking about $200 a year difference in terms of how much somebody has to pay and I think it would not be at all difficult for households to handle that extra amount of payment. What we are saying, they are going to have to pay over the last part of the plan $200 a year more.

The CHAIRMAN. Do you feel there would be a tendency for the mortgage lenders to give a young affluent couple, highly educated and obviously upward bound the loan as compared to not making that available to a moderate income blue collar family that was likely to have a fixed income?

Dr. ROSEN. I think there may be some problem with that. Lenders may want to be more selective in making the graduated payment loans and may select people they consider better risks.

The CHAIRMAN. But aren't these just the people who today now are moving into the suburbs and normally are able to find some way of financing a home, of getting a home?

Dr. ROSEN. I think this program will be used by new home buyers and it will be used by middle income home buyers. There's no way you can call this a low income program. However, if there's private insurance lender reluctance to use FHA in this case would be substantially reduced, and I have spoken to a number of lender groups and they do respond quite positively knowing the problems they have had making loans to young families who even have two earners in the family. They may be a little more selective but if there is insurance, both private and FHA insurance, I think there will not be a lot of discrimination.

The CHAIRMAN. Part of the problem involved here is the way the consumers will really view it once it gets going. I remember I was stuck once with a variable rate mortgage. I didn't know I had it. I got rid of it as soon as I could and it was a terrible experience for me. I'll never forget it. The testimony of mutual savings banks points out the consumers are likely to be confused and unhappy when they pay their mortgage payments but they see their outstanding loan balance increasing in the early years of the loan and no increase in their equity.

Do you have any evidence that consumers will understand that and realize what they are doing when they use the GPM?

Dr. ROSEN. I don't have personally, but I have an alternative type loan from Princeton University and they spelled out all the details very carefully to me.

The CHAIRMAN. But you're an extraordinary fellow. You understand it, sure. If you didn't understand it, we'd really be in trouble. You're the outstanding expert in the country on this.

Dr. ROSEN. I think there have been some studies in California where if you have a set of charts and show them the full payment stream and also make it clear to them this is a choice and you're not forcing this on them, and if you show them the payments are only $200 more a year over the remaining part of the loan and the choice is of getting a house or not getting a house, a lot of consumers may choose this.

The CHAIRMAN. If we had Dr. Rosen or Senator Brooke sitting there explaining it to each person with charts, I think that would be fine, but I wonder if you're going to get your mortgages really borrowed on that kind of basis.

Dr. ROSEN. The mortgage is a complicated instrument at present I think that there has to be—there always is some explanation of what goes on. I think I really have a lot of confidence in the savings and loan officers and the mortgage loan officers and I think this will not be hard to explain, especially since the payments—are all known in advance. There's no variation as you have with the variable rate mortgage. You know all your payments in advance. There's no uncertainty. You know exactly what you're going to pay every month over the life of the mortgage.

Senator BROOKE. If the Senator would yield, we will have testimony later this morning from Dr. David Smith who has already marketed these loans under the HUD experimental program. I believe that he will testify that he has had no great difficulty in having this understood by the home purchaser. I don't think that's really going to be a problem. These are people who could not otherwise afford to buy a home. That is why they would choose a GPM. And, of course, the mechanics of the GPM would be fully explained to the potential borrower.

The CHAIRMAN. Now we haven't yet received the Treasury's testimony. They will be testifying tomorrow as you know estimating their revenue loss for individual housing accounts, but it's bound to be substantial as you concede in your statement.

What makes you feel that this is a more efficient way to help people buy homes than it would be to spend the same money simply subsidizing the interest rate? We have programs to do that. I have supported them. Others have. Why isn't that a more efficient way to do this?

Dr. ROSEN. Subsidizing interest rates is really aiming at different questions. It's aiming at the graduated payment question. The interest rate effect—I think you get the same advantage for no dollars with the graduated payment mortgage.

The CHAIRMAN. I'm awfully suspicious when you say for no dollars.

Dr. ROSEN. I think that's really the case. The mortgage instrument has really become the constraint in terms of monthly payments.

The CHAIRMAN. You conceded $600 million a year.

Dr. ROSEN. That's for the individual housing account and that's aimed at the downpayment problem, not the mortgage interest problem. There are two things. You have to look at the downpayment and you also have to make your monthly payments, and the subsidized interest rate will only affect the monthly payments, not the downpayment. The reason the individual housing account is so useful, is that it is going to encourage people to save more than they would otherwise and it's going to help meet the downpayment constraint. The subsidized interest rate is really aimed at the monthly payment question and if I'm correct it's really this inflationary surge that's raised the mortgage rates up at the front end and the graduated payment mortgage alleviate this at very little cost to the government.

88-114 O - 77 - 2

The CHAIRMAN. If we could find a solution to the downpayment problem, then the subsidized interest rate would be comparable to what you're doing with GPM.

Dr. ROSEN. I think it would be comparable. However, it would be very expensive because your subsidies are over the whole life of the mortgage. That's quite an expensive proposition.

The CHAIRMAN. I'm not so sure that you couldn't do the same kind of thing there that you're doing here, why you couldn't phase that in, too.

Dr. ROSEN. You're saying over a 5-year period or something like that?

The CHAIRMAN. Yes.

Dr. ROSEN. It would do the same thing but I guess I find it hard to understand why we want to do it directly. Why use the direct expenditure when it really is the instrument that is creating the problem? It's not the interest rate itself, but it's the instrument that has caused this sort of inflationary induced surge in payments, and I think if you look at all the studies that have been done—and a lot of them have been academic but also by the industry—I think this is the general concensus, that this really has caused this tilt up in payments because of the inflation rate.

The CHAIRMAN. Of course, I'm also concerned with the possible discrimination factor against people with steady incomes and not upward bound. Do you feel lenders are likely to offer GPMs at times when they are basically short of credit in view of the fact that GPMs provide for a low cash flow in the early years and may involve complications in dealing with borrowers?

Dr. ROSEN. As I say in my testimony, if we were in a credit crunch in the next 3 or 4-year period—and almost surely we will be in one at some time in the next 3 or 4-year period—there will be some problem. It won't be major, but I think the lender will be less likely to make a loan like this as his cash flow is lower, as you pointed out accurately, and I did say the same thing in my testimony. I think that could be handled if the Federal Home Loan Bank Board were able to make extra reserves available.

The CHAIRMAN. This would mean at a time when the housing is in trouble and the credit crunch is biting there would be less activity here too. You indicated in Germany that was countercyclical and that kept housing alive.

Dr. ROSEN. That was the individual housing accounts. These provided the steady flow of funds and they did not experience disintermediation problem and that's what's so interesting about this combination of programs, that one offsets the other during a credit crunch, and that's what's so nice. There's a much steadier flow of funds because people are saving. It sort of gets back to the initial principles of a savings and loan association and a mutual savings bank. You save the money for your own house and we have sort of gotten away from that over time.

The CHAIRMAN. Doesn't this also argue the problem with the difficulty with getting loans in the inner-city—isn't it less likely that a lender would make a loan on a property that has a high risk element

such as an inner-city property? Do you feel that might be a drawback of GPMs?

Dr. Rosen. I think it probably would—they would be more unlikely to make a GPM in the inner-city, but he still has the conventional instrument. The lender would prefer not to make the GPM—this is not better for the lender, so I think he will be willing to make conventional loans in the inner-city or as willing as now, I should say.

The Chairman. The expansion of GPM to unlimited FHA loans is still limited to a very tiny fraction of the market because FHA has been very small compared to what it used to be or what it should be. Would you support expansion of GPM to conventional loans at the time and, if so, would you suggest any limitations?

Dr. Rosen. No. I would support that very strongly. I would suggest that for the GPM instrument—you probably want to talk about a downpayment of 10 percent because there is this negative amortization in the early part of the loan. However, as I indicated, two of the largest private mortgage insurers have made a commitment to insure all comers on GPMs on conventional loans so there will be protection for lenders making this loan and I would very strongly urge that the conventional market be brought into this because otherwise it's not going to have much of an impact at all on the housing market.

The Chairman. Senator Sparkman.

Senator Sparkman. Mr. Chairman, I think you have covered the field. This has been quite a lesson to hear this professor give us the testimony he has and I appreciate it very much.

The Chairman. Senator Brooke.

Senator Brooke. Dr. Rosen, you just said in response to the chairman's question relative to the lender giving GPMs—that lenders would prefer to give conventional mortgages, but they also get a benefit from GPMs in that they are reaching a group of young people who will be their future clients, who would and I quite agree otherwise not be able to enter the housing market. Is that not correct?

Dr. Rosen. That's correct, and that is the response I have gotten when giving speeches—we don't like it as much, but we want to do it. We have these people coming in and we want them as clients. In speeches I have made before banking organizations this has been the response. They will be very happy to do this.

Also, there is another benefit. Over the life of the loan the consumer is going to pay more interest, so over the long run the lender is going to get more money than he would otherwise.

Senator Brooke. An enlightened banking institution will recognize that there has been a decade or so of young people who have been denied the opportunity to buy their first home. If they offer GPM's, they would be able to lend them money for the purpose of buying a first home and would establish the future clients that they need.

Mr. Rosen. I also want to thank you for the excellent statement that you have given and the candor and objectivity with which you have responded to the chairman's questions.

Dr. Schechter, who will be testifying tomorrow, maintains that the graduated payment mortgage program will significantly increase the total cost of obtaining free and clear ownership of a home. He also

feels that some borrowers would actually be squeezed out of the market by upwardly mobile families using the GPM as the Chairman has suggested, if there is wide acceptance of that program.

Now you have given us your general views, but would you elaborate on this point because I think it's important to determine what the impact of the GPM will be on borrowers who are not now able to become home owners and on borrowers who can afford to buy a home.

Dr. ROSEN. I think that the key thing to realize is that this is providing a choice and the choice is for many families of buying a home or not buying a home, and by providing the GPM you're really saying if you allow those people who really wouldn't qualify for a mortgage to qualify, so I think Dr. Schechter is probably wrong in the case of squeezing out those people because they are not able to buy a home now, and what you're doing is letting that group in.

The upwardly mobile family probably would not use this. Somebody making $35,000 is going to calculate out and know what he has to pay over the life of the mortgage.

Senator BROOKE. I don't think that kind of family will not wait 4 years to purchase a home.

Dr. ROSEN. That's right. I think it's really going to hit the exact people you would like to. The other thing that I would say about this is it seems to me that during periods of tight money there might be some problem and one would have to calculate that exactly, and I think there might be some problem to the extent banks might not want to issue GPMs or might be more reluctant to issue GPMs. We have another source of mortgage money, the Brooke-Cranston program, which I hope if we do get into another credit crunch problem we will have that reactivated during a credit crunch. So we have other ways of meeting that supply period during a credit crunch.

Senator BROOKE. We'll get to that later.

The CHAIRMAN. I'm hoping Ed will support his legislation which I now champion and he's kind of left it as a stepchild on somebody's doorstep.

Senator BROOKE. Not at all. I just question whether there's a need for the program at the present time. I have no intention of abandoning the child by any means. As I say, I birthed that child with Senator Cranston. I love the child and I think it's a good child.

The CHAIRMAN. But you let me do the babysitting for a long time now.

Senator BROOKE. No. It's behaved well, but I just don't know that the child needs to perform at this time because of the market conditions. What do you think about that?

Dr. ROSEN. I would just say that the key thing that's useful in the Brooke-Cranston program is that it's really meant to be countercyclical. When we get into the credit crunch that's what we need, the money in the mortgage market. It's hard to believe this, but the S&Ls are now stuffed with money. If you put more money in the market you're going to exacerbate the boom that's already coming and overbuilding, and I think you have to be careful about that. If you're king about a subsidized interest rate, you should do that directly you shouldn't do that through the Brooke-Cranston program.

There are other ways to subsidize low and moderate income households. This is not an effective way of helping low income households obtain entrance in the housing market.

Senator BROOKE. I certainly agree with your position and I hope our Chairman does as well.

Now, Dr. Rosen, if the graduated payment mortgage became widely accepted, could you estimate how many families—I think you gave the Chairman some estimate—would be likely to purchase homes under this? We have heard some very large numbers. We have heard as many as 2 million. I think you mentioned the 600,000 figure in response to the Chairman's question. Is that a result of any study that has been made at Princeton or elsewhere?

Dr. ROSEN. I think it's really hard to know how many people would use the GPM. There are, as I said, approximately 5 million new households who would be on the market in the next 10 years. I would say, in the absence of any real study in terms of consumer preferences, I think one really can't say how many will use the GPM. I would estimate that it's conceivable that it would put 2 million people in the market who would otherwise not be in there but would have to postpone it, but I think that's a reasonable figure.

Senator BROOKE. How long a period?

Dr. ROSEN. A 10-year period.

Senator BROOKE. Now how many would likely be families who could not otherwise afford to purchase a home?

Dr. ROSEN. I would say probably half of those would be families who would not be able to buy a home otherwise. Again, I would like to see a study of this. I think that there are some studies going on now sponsored by the Federal Home Loan Bank Board which might shed some insight on consumers' attitudes toward alternative mortgage instrument, and I think when those come out it would be very useful to look at those.

Senator BROOKE. You mentioned Canada and Germany. Both countries have home ownership savings plans which are similar to what we are proposing in this legislation. In particular, what have been their findings regarding revenue loss and expansion of the housing market to those who would not otherwise afford to purchase a home?

Dr. ROSEN. In Canada, which is obviously a much smaller economy, and there's some numbers in the testimony. They found their program to be very, very helpful in terms of encouraging savings for housing. In terms of revenue loss, I think one thing they found is that everybody does not participate in this program. Only approximately 50 percent of the people who would be buying a home would actually participate. When you talk about revenue loss all of the other estimates I have seen assumes that everybody that buys a home is going to use this plan. Approximately 50 percent in Canada who buy a home have actually been using this program. So the revenue losses don't look very bad. They look at the revenue loss against people buying homes and employment and this sort of thing and they would say there isn't really a revenue loss at all. I would disagree with that sort of analysis. I think there is a revenue loss and we have to realize there will be one.

In Germany—this is not exactly the same plan but it is a program aimed toward saving for housing. They have found that during the last credit crunch, there was no downturn in housing, and that was really an astounding thing because that's one of the major problems the housing industry has here. If we could somehow assure a more constant flow of funds when we talk about hot money and these sorts of things, I think that would really help the industry.

Senator BROOKE. Now I refer to David Smith, and he will testify shortly, but in his testimony he recommended reduction in both the maximum annual deduction and the maximum lifetime deduction under the individual housing account to $1,500 annually and a total of $6,000.

So in light of your testimony and the tremendous increase in cost that you predict, do you feel that a reduction of this nature that Mr. Smith mentioned in his testimony will provide sufficient funds for a young family to purchase that first home?

Dr. ROSEN. I think at the present time it probably would be a reasonable order of magnitude, but as the forecast for the next 10 years shows we are going to be talking about a downpayment of $23,000 or $25,000 10 years from now and many families are not going to save this money in 4 years, $1,000 a year over a 10-year period. I think it would be a mistake to reduce it dramatically.

One thing I would add, one wants to at least have a family hold this account for a 1-year-period. Someone should not be able to use this on January 1st and take it out January 3rd and use that as a deduction. I think one would clearly want to make the household hold this individual housing account for at least 1 year before using the deductibility provision. I think that would also reduce the cost of the program. I guess I would like to see it on the order of magnitude we're talking about because of the substantial increase in downpayments we'll be seeing over the next 10-year-period.

The CHAIRMAN. Senator Lugar.

Senator LUGAR. Professor Rosen, what is your general estimate as to what the compound rate of inflation will be in this country over the next 20 years or for the next 10 years? And I ask this just simply because I think it's relevant to try to figure out what sort of problems the average homeowner or home buyer might face.

Dr. ROSEN. That, of course, is a question we would all like to know the answer to. I estimate inflation rates anywhere from 4½ percent up to 7½ percent. My best estimate, given the energy situation we are going to be facing, given that land prices are not going down and we are really running out of urban land close to metropolitan areas, and given the tremendous boom on households coming on to the housing market, my best estimate is probably the inflation over the next 10-year period will run about 7 percent.

Senator LUGAR. Your testimony reflects generally the thought that we will probably have some inflation. I think that's an implicit assumption and it has the intriguing suggestion with which I agree that people will have to become economists or at least increase their economic understading substantially to understand some of the reverse aspects of this plan that are not a part of constant payment situations of a conventional mortgage.

For example, it seems to me that it's extremely important that people might find that, as you pointed out, at the end of a number of years that they owe in numbers of dollars more money than they did at the start. I think it would be fairer to say however, that if we were to use some sort of index as to the real value of those dollars. in fact, although the number is higher, the value is much lower and that therefore the individual probably is considerably better off. Is that a fair characterization?

Dr. ROSEN. I think it's a fair assessment and also it's a little bit shocking when you view these inflation rates out in 10 or 15 years, the numbers get so large, and we are going to have to become more sophisticated I think and we have no choice but to adjust. It would be nice if we could lower the inflation rate substantially and I hope so, but we are in a world economy and we can't dictate what the rest of the world is going to do about many of the basic raw materials and oil prices, and we are going to have to adjust—our institutions are going to have to adjust and households are going to have to adjust to a higher inflation rate than what we would like to see or than we are accustomed to.

Senator LUGAR. I'm dedicated to trying to reduce the level of inflation and I'm sure the members of this committee would like to see that too. I think the importance of what you're saying today and the importance of these bills is a recognition with regard to homeownership, that with the underlying, almost built-in index factor of inflation that currently exists in our economy, and with our common goal of having homeownership increase, we are going to have to improvise methods that take a look at the real world as opposed to one that simply doesn't exist given this inflationary bias.

Now I'm impressed by the beginning of your statement that we are in for some very profound political reverberations as the American public begins to sense that the homeownership dream is not only diminishing but that for a vast majority of people it's over altogether. I simply do not share the viewpoint of many who would say simply and with resignation that we all have to live in boxes or in some other similar fashion and that we are a pampered and spoiled nation that has become accustomed to single-family houses almost as if this were sinful. I think in fact this is a very good objective, that people ought to have housing and that young families or middle-aged families or whatever their circumstances, move out. But clearly under the current pressures that is not going to be the case and unless we adopt some plan such as this legislation it's not going to be the case.

Now let me pose the question Senator Brooke posed in a little different way. Appreciating that we do not know how much the tide will bear with regard to the individual housing account and that we are going to hear testimony that $2,500 was too much and $1,500 ought to be the proper figure, what is your judgment, if you were to start from scratch with this individual housing account legislation? Would you have proposed the $2,500 or is there a case to be made that it should be $3,000 or $3,500 or what sort of criteria or benchmarks really should we look at in trying to determine that amount?

Dr. ROSEN. I think the key criteria is what is the downpayment going to be in 3 to 5 years because you're talking about somebody who's going to take 5 or 6 years to accumulate that downpayment. I think that's the criteria and as I said it looks as if it will be substantial. The actual $2,500 is really not the real question. I think the question is how much of a tax benefit is the person getting, because he's putting his own $2,500 aside. We could handle the same thing through a tax credit. If you wanted to give a tax credit of $500 or on the order of $625 you give a tax credit and you wouldn't have the regressivity problem and you know exactly what your expenditure would be. This way it really depends on the tax rate of the person and these sorts of things. So you have to realize $2,500 is not how much the Government is putting up. The Government is putting up $625 and it may be better to do it through a tax credit rather than deductibility, but that's something you have to think about carefully. The Canadian program allows the husband and the wife to accumulate $1,000 a year for a total of $20,000. So our program is substantially lower.

Senator LUGAR. The Canadian program is already in place?

Dr. ROSEN. The Canadian program is already in place, since 1974. One thing, they only allow $1,000 per year in Canada, but they assume it will be a 10-year period that it will take you to accumulate the downpayment.

Senator BROOKE. We had that recent Harvard-MIT study which predicted the median cost of housing in the next 5 years would be $78,000. Dr. Rosen previously testified that by 1986 that the median price would be $90,000. So I think the projections of the $2,500 to $10,000 savings for a down payment are based upon a projection of the median cost of housing.

Senator LUGAR. Just following that up for a moment, it seems to me that clearly in the discussions that many of us have had about the capital crunch that is envisioned, that this is another element of saving that is a very good one as a social objective.

Let me ask you this. If in fact many persons in this country began to save money in these accounts, would this address in a way the problems of capital crunch in the housing market? Is it likely, for example, that this money would be deposited in savings and loans as opposed to other sorts of banks or do you characterize how any of this money might flow into the housing market and to what extent it's a countercyclical factor?

Dr. ROSEN. I would think, first of all, that probably the proportions of deposits would be somewhat similar to what they are now in terms of savings and loans and commercial banks and mutual banks. I think this would be countercyclical in the sense you would have a more stable source of funds that people would put aside every year and it would be countercyclical as has been shown in Germany it is because it's kind of like a contract for savings. In terms of capital shortage, I think this will definitely help the housing sector because this is earmarked money for housing that might not have been there otherwise. I should be honest. I do think a portion of this money—and I don't know what portion—will be reshuffling of money, money that's already in there, and they will just move it over to this ac-

count. That's not going to be as large as you think because people that have that downpayment are not going to wait to buy a house. With a rate of 5 or 7 percent inflation, they would make more in capital gains than they would in tax benefits. They are not going to wait just because there's a tax benefit. They are going to buy a house as soon as they can.

One might want to raise the penalty. We talked about the penalty for withdrawal to nonhousing purposes. One might want to raise the penalty to 20 percent, if one is worried that people would use this as a tax shelter other than for housing purposes.

Senator LUGAR. Would you favor this as a one-time situation; that is, as a housing account for the first house, or would you favor this continuing as people thought of the second or third purchase?

Dr. ROSEN. I think it should be only for the first house. The first time the person has bought a house, because once you're into the housing market you get a capital appreciation and you then have enough to make a downpayment on the other homes. So it's just for the first time home buyer. That's what I would like to propose. I think that makes more sense.

Senator LUGAR. Thank you very much.

Senator BROOKE. Mr. Chairman, I have more questions which I would like to have submitted.

The CHAIRMAN. I do, too, and, Dr. Rosen, the question that I'd like you to address for the record—not now—is the question of really how similar the programs in Canada, Germany, and elsewhere are. They are not the same, by any means, as you know. They are quite different, and if you could give us your detailed analysis of how they differ so that we would have that before us when we decide on this bill we would appreciate it. Thank you very, very much for a superlative performance and it's been most impressive.

[Complete statement of Dr. Rosen and copies of the bills being considered follow:]

THE HOUSING CRISIS AND THE YOUNG FAMILIES HOUSING ACT*

Kenneth T. Rosen
Professor of Economics
and Public Affairs
Princeton University

The United States is today in the midst of a housing crisis of unprecedented proportions. The magnitude of this crisis can be best appreciated by considering the simple fact that nearly 2/3 of all American families could not afford to purchase the home in which they now live. Of more immediate concern, however, is the fact that most new entrants to the housing market (young families and other first time homebuyers) cannot afford to purchase <u>any</u> home at all. The proximate causes of the crisis are: high and rapidly rising home prices, high mortgage interest rates, substantial and often prohibitive downpayment requirements and high maintenance and utility costs.

The consequences of these market conditions are that an increasing number of Americans are becoming "housing poor" and that the institution of homeownership has over the past few years become available only to the fortunate few. Those fortunate few include households who entered the market prior to the inflationary induced surge in housing prices and mortgage interest rates, and those families earning an annual income over $20,000. This of course excludes most low and middle income households, most minority households, and most young families.

Thus, the "American Dream" of universal homeownership is virtually dead in the present economic and institutional environment. This frustration of a basic societal goal can be expected to lead to increasing consumer and political dissatisfaction and will quickly lead to a national perception of the magnitude of the "housing crisis."

*The Young Families Housing Act (S-664) was introduced by Senator Edward Brooke (R-Mass.).

The purpose of this paper is to briefly examine the magnitude of the housing crisis and to outline a proposal (the Young Families Housing Act) which may alleviate the worst aspects of the "affordable housing problem."

The Nature of the Housing Crisis

The origins of the present housing problem can be explained by examining the interaction of two major factors: 1) the highly inflationary environment of the past five years and 2) the outdated institutional mechanisms, built for a non-inflationary world, which define the mortgage lending system.

The highly inflationary environment of the past five years has of course had adverse effects on the entire economy. The housing sector, however, has been especially damaged by the inflationary forces. In particular the relative cost of homeownership has risen substantially since 1970. As the chart that follows shows, the cost of homeownership has risen at an annual rate of 8.3% compared to an overall rate of change in the CPI of 7.7%. The key elements of this relative price rise have been rapidly rising sales prices, rising mortgage interest rates, and rising utility and maintenance costs. The sales price of a new home has risen at an annual rate of 9.4%, while an existing home has risen at a rate of 10.7%. These relative price rises are a result primarily of the inelastic supply of land and construction materials and labor.

The interest on the mortgage loan has also been affected by the rate of inflation. The mortgage interest rate is a function of the expected inflation rate and a real interest component. The high inflation rates of the past five years have raised the contract interest

TABLE 1

HOUSING COSTS

	(1) Homeownership Component CPI	(2) Sales Price of New Home	(3) Sales Price of Existing Home	(4) Effective Mortgage Interest Rate	(5) Gas & Electricity Housing Component CPI	(6) Down Payment Requirement on New Home	(7) Per Capita Disposable Real Income	(8) Overall CPI
1970	128.5	$28,900	$23,030	8.45	107.3	$8,178	$2,610	116.3
1971	133.7	$30,300	$24,810	7.74	114.7	$7,787	$2,682	121.3
1972	140.1	$32,200	$26,710	7.60	120.5	$7,470	$2,779	125.3
1973	146.7	$35,600	$28,920	7.95	126.4	$8,081	$2,944	133.1
1974	163.2	$38,900	$32,040	8.92	145.8	$9,413	$2,844	147.7
1975	181.7	$42,500	$35,330	9.01	169.6	$10,158	$2,830	161.2
1976	190.7	$48,000	$38,100	8.99	187.9	$12,500	$2.951	170.1
Annual Rate of Change (%)	8.3	9.4	10.7	1.3	11.6	4.8	1.7	7.7

Source: Federal Reserve Bulletin, Federal Home Loan Bank Board Journal, Bureau of the Census (C-27)
National Association of Realtors

rate and so raised the monthly carrying costs of a conventional mortgage by nearly 20%. Compared with a 1-2% inflation world, the present monthly carrying costs of a conventional mortgage are nearly 50% higher than would be expected in a low inflation economy.

In addition to these carrying costs, the operating cost component of housing expenditures has also been adversely impacted by the inflationary environment. This is especially true in recent years when households have been forced to absorb large utility cost increases.

A final adverse impact of inflation on homeownership relates to its impact on the initial entry barrier as represented by the downpayment requirement. Since 1970 the median downpayment on the median priced home has increased by nearly $3500, 4.8% per year. The present median downpayment requirement of $11,500 on the median priced home is clearly a major barrier for the first time entrant to the housing market.

While the previous analysis indicates that the housing market has been severely affected by the inflation of the past five years, the outlook for the next ten years is even more discouraging.

Our analysis indicates that their will be a major increase in the number of young households coming onto the housing market from 1977 to 1986. The number of young family households (25-40) entering the market will be 7.1 million, a 31% increase over the number of young family households entering the market from 1968-1977. This boom in young households, however, will be confronted with a major explosion in housing prices and downpayment requirements. By 1986 the median priced new home will sell for close to $90,000 with the average downpayment required averaging close to $23,000. These numbers assume a 7% inflation rate in the overall economy. The housing market inflation rate is forecast to be over 10%, with the average mortgage interest rate for the period forecasted to be at 10.7%. The impact of the inflation will be to raise the cost of

homeownership by nearly 12% a year. This forecasted cost and price explosion will in turn make it impossible for nearly 2.5 million of the 7.1 million young family households to buy their own homes. Thus, nearly 1/2 of those young households who would normally be able to purchase a house will be unable to do so without a change in the present institutional arrangements. Chart II and III graphically illustrate this cost and household explosion.

The one potentially positive impact of inflation on the housing market concerns the households' ability to pay for housing over the life of the mortgage. During most periods of normal economic growth, the households' money income would be expected to rise at a rate greater than or equal to the rate of inflation. In this normal case, the nominal amount of a mortgage loan that could be supported, would rise in an inflationary world. Of course, the recent inflationary experience was far from normal. In 1974 and 1975, real per capita disposable income fell, and a large number of individuals experienced unemployment and falling real income. Over the long-run, however, the expectation of rising real income in the economy is probably valid for the vast majority of households. This would allow the household over the life of the mortgage to support at least a constant real stream of mortgage

payments, which in an inflationary world implies a rising nominal path of mortgage payments.

These inflationary effects can then be juxtaposed with the traditional institutional mechanisms of the mortgage market. These institutional arrangements were basically established for a low inflation world. The standard mortgage instrument is basically a level payment, amortized loan. This loan is not well adapted to an inflationary environment. It takes no account of inflationary induced rises in money income or inflationary induced increases in the underlying value of the property. Thus, from the borrower's viewpoint, the standard mortgage instrument completely ignores the inflation induced dynamics of the housing market. On the other hand, from the lender's point of view, the standard mortgage instrument does attempt to anticipate the influence of an inflationary environment on the particular contract. Through the calculation of the mortgage interest rate, the lender attempts to incorporate expectations of inflation over the life of the loan.

It is this situation which has created a dynamic mismatch between the cost of the mortgage loan to the borrower and the borrower's ability to pay. This dynamic mismatch, caused by the failure of the standard mortgage instrument to adapt to an inflationary environment, is a major element of the housing crisis.

The extent of this mismatch can best be illustrated by a simple example. For this example, we assume that a household with an income of $15,000 takes out a $30,000, 8-1/2%, 25-year mortgage. Further, we assume that the economy experiences a 5% annual average inflation over the life of the mortgage, and that the household experiences a 2% real

income growth per year. Table II and Figure I, show the dynamic payment streams in both the 5% and the no inflation world.

It is quite clear from these comparative examples that a moderate inflation rate induces a major distortion in the time path of payments relative to income. A 5% inflation rate more than doubles the initial payment/income ratio compared to the no inflation world. In contrast, by the tenth year, the household is paying only 10% of his income to amortize the mortgage, while by the last year of the mortgage he is only paying 3.3% of income for the mortgage. His real payments would have dropped from $2753 per year to only $764 per year by the final year of the mortgage.

Recognition of the limitations of the standard mortgage in an inflationary environment is fairly widespread in the academic and research worlds. A major study undertaken at MIT, entitled New Mortgage Designs for Stable Housing in an Inflationary Environment, has evaluated the theoretical and empirical aspects of a number of alternative mortgage instruments. These included the variable rate mortgage, the price level adjusted mortgage, and various combinations of these and other instruments. In addition, the four largest savings and loan associations in California have on their own proceeded to adopt the variable rate mortgage.

Nevertheless, despite such research and real world experimentation, the concept of an alternative mortgage instrument has generally stirred much political and consumer opposition. The reason is that the alternatives proposed require substantial changes in the existing institutional environment. These changes are often perceived as complicated maneuvers stacked against the consumer and in favor of the lender. These perceptions,

TABLE II

Impact of Inflation on the
Mortgage Instrument

No Inflation World
3 1/2% Mortgage Interest Rate
$30,000 Mortgage

(1) Year	(2) Annual Nominal Payment	(3) Annual Real Payment	(4) Annual Nominal Income	(2)/(4) Payment / Income
1	1272.24	1272.24	15000	8.48
5	1272.24	1272.24	16561	7.68
10	1272.24	1272.24	18285	6.95
15	1272.24	1272.24	20188	6.30
20	1272.24	1272.24	22289	5.70
25	1272.24	1272.24	24609	5.16

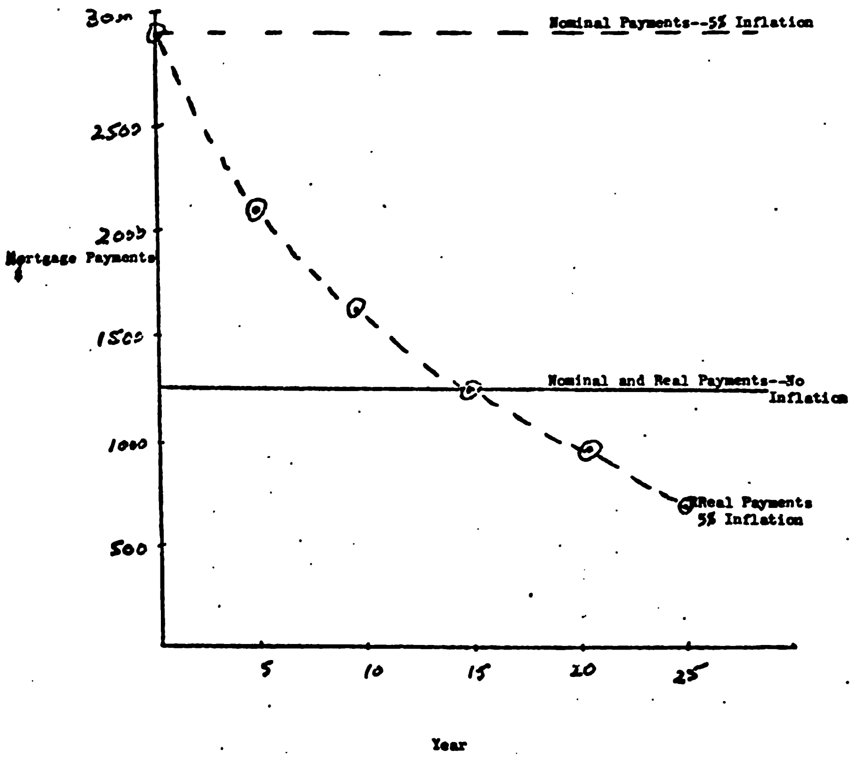
5% Inflation World
8 1/2% Mortgage Interest Rate
$30,000 Mortgage

(1) Year	(20 Annual Nominal Payment	(3) Annual Real Payment	(4) Annual Nominal Income	(2)/(4) Payment / Income
1	2898.84	2753.89	15000	19.32
5	2898.84	2130.91	21038	13.77
10	2898.84	1648.86	29507	9.82
15	2898.84	1275.85	41385	7.00
20	2898.84	987.23	62108	4.66
25	2898.84	763.90	87109	3.32

88-114 O - 77 - 3

Chart I

Nominal and Real Payment
Streams in a 0 and 5 % World



whether or not justified by the facts, will continue to provide obstacles to the swift adaptation of the mortgage to the problems of inflation.

Young Families Housing Act

With these institutional and market difficulties in mind, it seems appropriate to propose an alternative package of housing market policies. The package we propose consists of two elements: 1) a graduated payment mortgage (GPM) instrument and 2) an individual housing account (IHA). The former (GPM) is an attempt to correct the dynamic mismatch between mortgage payments and income, induced by inflation. The GPM necessitates little change in the existing institutional and legal situation. It merely involves making permanent the experimental FHA insurance program provided under Section 245 of the National Housing Act.

The later proposal, the individual housing account (IHA) is an attempt to provide a mechanism for the first homebuyer to accumulate the substantial downpayment requirement for a home purchase.

Graduated Payment Mortgage

As compared to the conventional mortgage loan the Graduated Payment Mortgage (GPM) provides lower monthly payments on the mortgage during the early years of the loan and higher payments in the later years of the loan. This payment pattern allows the household to take advantage of the positive effects of inflation which will increase its income and property value over time. A number of different types of GPM's are now being insured by FHA. The amount of graduation varies from 2% to 7.5% and the graduation lasts from five to ten years. The GPM plan should be especially appealing to the government as it provides a way of improving the ability of young households to purchase

homes without direct federal expenditure. What is required is that FHA insure such loans and that Federal regulatory agencies allow and encourage the granting of this type of loan.

The impact of the graduated payment mortgage (5% graduation for first 5 years) can probably best be seen by examining a simulated example of the loan. For this illustration, it is assumed that a household with an income of $15,000 in the initial year purchase a $40,000 house, with a $30,000, 8-1/2% mortgage loan amortized over 30 years. These terms and prices closely reflect the median conditions and terms currently prevailing in the market. It is also assumed that there will be a constant 5% rate of inflation over the life of the mortgage, that real income of the household will rise at 2%, and that the value of the house will rise at the rate of inflation. We can then compare the dynamic aspects of the standard mortgage instrument and the graduated payment mortgage.

In examining the comparative paths (see Table III and Figure IV*), we find that monthly payments in the initial year fall dramatically for the graduated payment mortgage loan. They drop nearly 18% compared to the payments due on a standard mortgage. Moreover, initial monthly payments drop from 19% to 15% of the household's income. This implies that given the existing institutional rule-of-thumb, a household earning only $12,000 per year would now be able to purchase the median priced ($40,000) home.

This focus on the initial year of mortgage payments is extremely important, since lenders view the relationship of these payments to money income as the major determinant of the amount of the mortgage loan (and thus the amount of

*Figure IV shows three variants of the GPM.

TABLE III

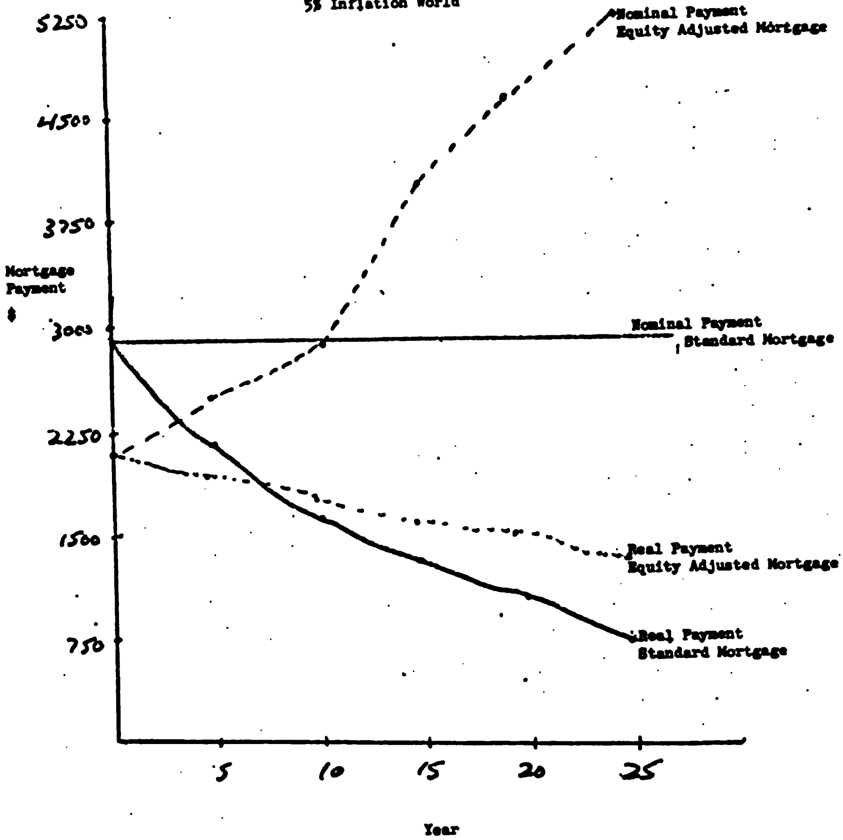
GRADUATED PAYMENT MORTGAGE

5% Graduation
5% Inflation
8-1/2% Interest Rate
$30,000 Mortgage

(1) Year	(2) Annual Nominal Payment	(3) Change in Actual Nominal Payment	(4) Money Income	(2)/(4) Payment/Income	(6) Property Value
1	2289.96	18%	15,000	15.3	$40,000
5	2783.52	0	21,038	13.2	51,051
10	2922.84	+6%	29,507	9.9	65.155
15	2922.84	+6%	41,385	7.1	83,156
20	2922.84	+6%	62,108	4.7	106,130
25	2922.84	+6%	87,109	3.3	135,451
30	2922.84	+6%	122,174	2.4	172,874

Chart II

Nominal and Real Payment Streams
Equity Adjusted and Standard Mortgage
5% Inflation World



housing) the consumer can purchase. It is quite clear that in this respect the GPM is superior to the standard mortgage instrument.

In terms of the dynamic relationship of monthly payments to income, the graduated payment mortgage again provides a better match between payment obligations and household income levels. In both instruments, payments as a percentage of money income declines over the life of the mortgage. The only difference is that the payment-income ratio declines more slowly in the case of the GPM than in the standard mortgage.* It is not until the 5th year of the loan that the payment-income ratio of the graduated payment mortgage is as high as that on the standard mortgage loan. In terms of actual monthly payments, the mortgage naturally shows a rising payment stream for the first five years. Again, however, it is not until the 5th year of the loan that the payments on this loan exceed those on the conventional mortgage. Moreover, it should be emphasized that the rise in money income has more than offset the rise in actual monthly payments.

To summarize the GPM allows a better matching of mortgage loan payments and the borrower's income by taking advantage of inflation induced rises in income and property values. If instituted, this will substantially increase home ownership opportunities for middle income and young families.

Several objections may be raised concerning the GPM. The first potential objection concerns the fact that for the first few years of the mortgage loan the nominal amount of the loan outstanding may increase. While this may be perceived as a "problem" by some lenders, it in fact makes perfect economic sense. As long as money income and property values rise faster than the

*It is possible to design a graduated payment mortgage loan that would allow the payment-income ratio to remain constant at the initial level. This would further reduce initial year payments and lower the entry income level to $8,000.

increase in the mortgage liability there is no increase in lender risk. This point leads directly to the second problem, that the individual borrower's income and the individual property value may not rise at the rate of inflation. In these individual cases, increased risk and increased debt burden may be incurred. These cases could be handled by some type of public (FHA) or private market (PMI) insurance. In most normal economic circumstances, and for the vast majority of properties and individuals, however, the expected secular rise in money income and property values will of course materialize.

The final problem with the GPM concerns the supply of mortgage funds during periods of tight money. Since the main feature of a GPM is a lower initial cash flow during the first five to ten years, the mortgage lender would be providing a larger loan to the borrower during this period. This would of course provide competition for funds which might otherwise be used to finance new construction or turnover in the existing stock. This effect must be weigned against the lower initial payment effect, which would reduce the household's sensitivity to changes in nominal interest rates. The combination of these two effects would determine the impact on the housing cycle.

Individual Housing Account (IHA)

The second part of the Young Families Housing Act involves devising a mechanism to slow the first-time home-buyer to accumulate the substantial down payment required to purchase a new home. Presently the young household needs $10-12,000 to purchase a home. As stated earlier by 1986 he will need between $20-23,000 as a downpayment.

It is proposed that the household be allowed to deduct up to $2500 per year from his gross federal income, and put this money in a segregated individual housing account (IHA). He would be allowed to accumulate up to $10,000 in this

account. At any point the household would be allowed to withdraw this money and use it towards the purchase of a home. As long as the IMA was applied towards the purchase of a home, no tax would have to be paid on this sum or the interest income which has accrued in this account. A tax recapture provision is provided for, in that the basis price of the home is reduced by the amount of IHA savings that the household has accrued. Thus the household incurs a capital gains tax liability on the IHA sum when he becomes subject to tax on his home. These special IHA accounts should be restricted to first time home-buyers, as this group of households would not have had the advantage of equity accumulation in an existing home.

It is clear that the IHA account idea is quite similar to the Individual Retirement Accounts (IRA) which have recently been introduced. The same sets of institutions would presumably respond to this incentive scheme. However, the individual participating would be very different. Since the program would be restricted to first time homebuyers it would benefit young and low and moderate income households.

A concept very similar to the Individual Housing Account is presently being used in Canada. The Canadians have adopted a plan known as the Registered Home Ownership Savings Plan (RHOSP).

"Essentially the RHOSP enables taxpayers who do not own a home to contribute up to $1,000 per year to a lifetime maximum of $10,000 in a RHOSP. The contributions to the plan and the plan's earnings are exempt from tax provided that, when the plan is collapsed, the proceeds are used for the purchase of a house or for furnishings at the time of first occupancy. Both husband and wife can have plans provided that they do now own a home, so that a family can contribute up to $20,000. No deduction for tax purposes may be made in any tax year in which a home is owned.

For the 1974 tax year, 231,000 RHOSP's were started and contributions totalled some $199.4 million. For 1975 tax purposes, 215,000 new RHOSP's were started." (in a letter from Hirsh Tadman, Canadian Finance Ministry.)

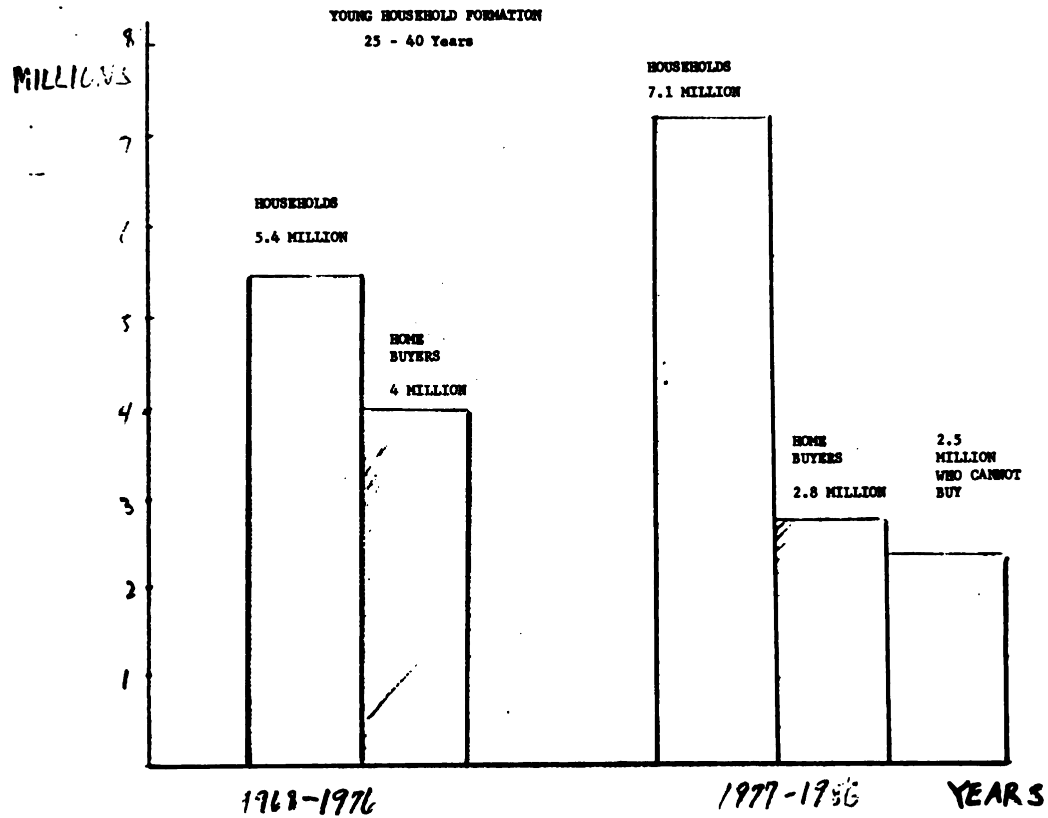
The advantages of the IHA are substantial. It provides a mechanism to stimulate savings in the overall economy, and thus may help avert a capital shortage in the housing sector. It provides a positive incentive for frugality and does not in any sense resemble a giveaway program. As a result the household will view his downpayment as his own equity. This will substantially reduce the probability of default relative to alternative programs which might reduce downpayment requirements for households. Thus with the IHA we are encouraging savings for housing, improving the supply of mortgage funds and the viability of thrift institutions, without increasing the default risk associated with low downpayment mortgages.

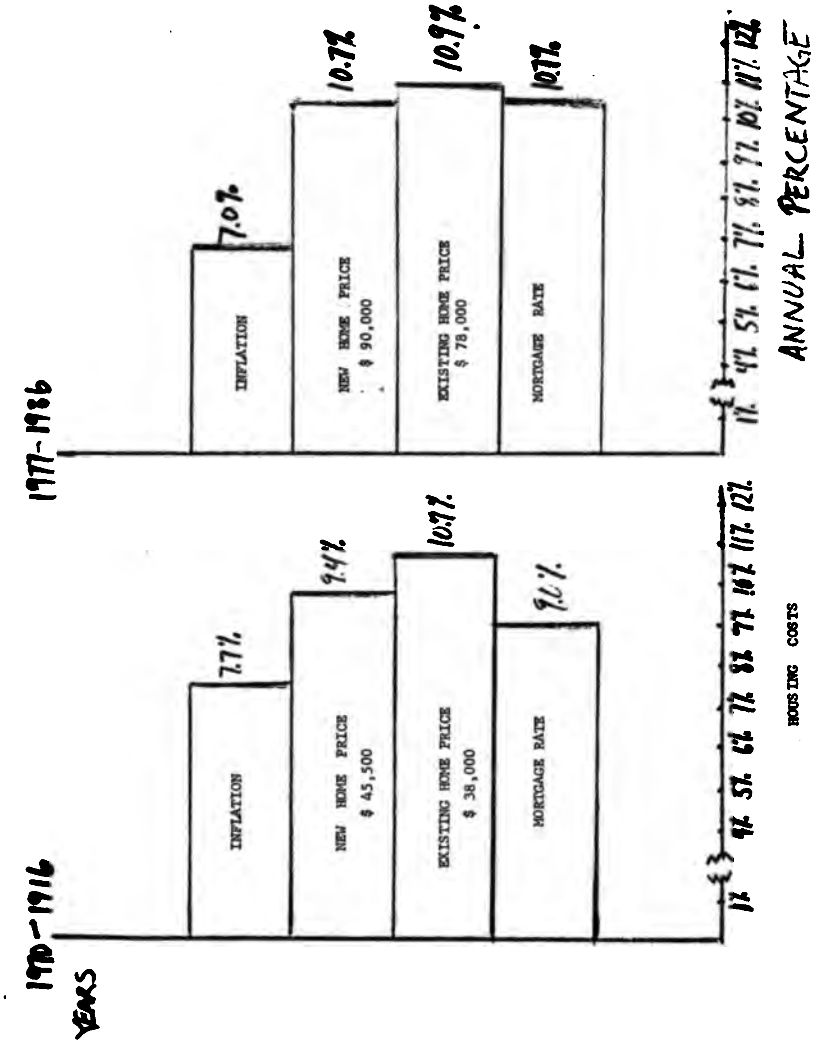
The one potential objection to the IHA idea, concerns the loss in tax revenue. The addition of the recapture provision to the earlier bill will partly alleviate the loss in revenue. Even with the tax recapture, the IHA involves a substantial tax expenditure especially in the near term. Assuming that 1 million households participate, and that each saves an average of $2500 in the IHA and is in the 25% tax bracket, the total maximum annual expenditures are about $625 million dollars. Over the next ten years perhaps 2.5 million households will participate at a cost of $6 billion dollars. However all this expenditure should be eventually recaptured.

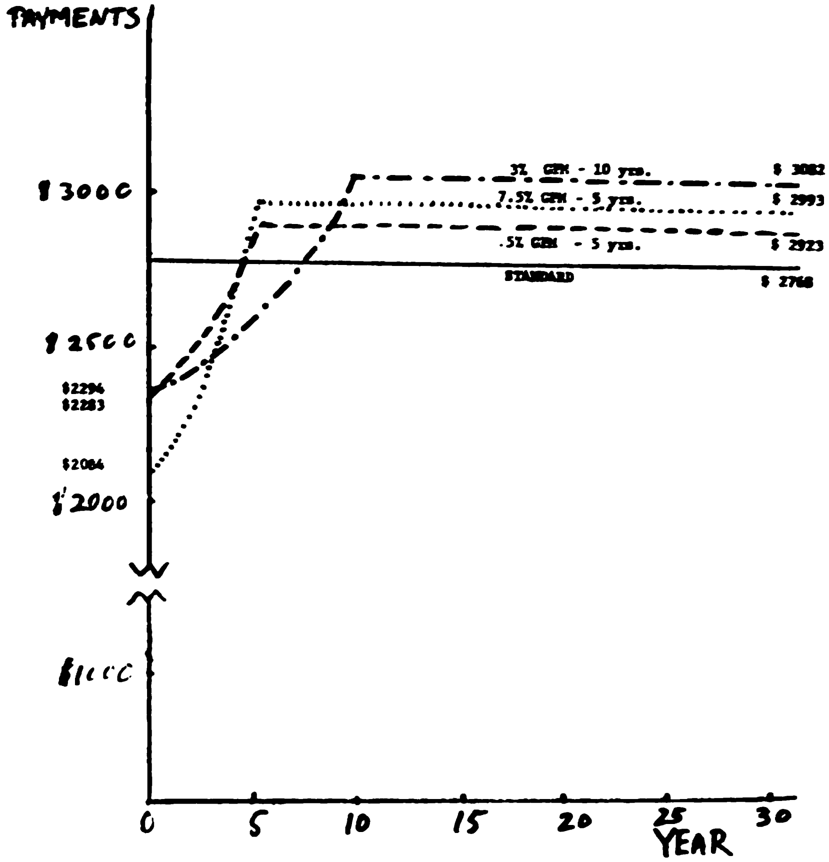
Summary

The design and impact of the Young Families Housing Act is two-fold. First, by the better matching of the households' income and mortgage payment stream it will reduce the initial monthly payment barrier by nearly 20%. This will substantially increase the homeownership market, bringing it within the reach of nearly 60% of all American families (versus only 40% of all families who can afford homeownership at present). Second, by helping the household accumulate the downpayment requirement it will increase funds available to the housing industry, encourage increased savings, and assure that homeownership will become financially feasible.

In this way, this program contributes to the goal of a decent home in a suitable living environment at an affordable cost.


YOUNG HOUSEHOLD FORMATION
25 - 40 Years
MILLIONS
8
7
6
5
4
3
2
1
HOUSEHOLDS
5.4 MILLION
HOME
BUYERS
4 MILLION
HOUSEHOLDS
7.1 MILLION
HOME
BUYERS
2.8 MILLION
2.5
MILLION
WHO CANNOT
BUY
1968-1976
1977-1986
YEARS


1970-1976
YEARS
INFLATION
7.7%
NEW HOME PRICE
$ 45,500
9.4%
EXISTING HOME PRICE
$ 38,000
10.7%
MORTGAGE RATE
9.0%
1%
4% 5% 6% 7% 8% 9% 10% 11% 12%
HOUSING COSTS
1977-1986
INFLATION
7.0%
NEW HOME PRICE
$ 90,000
10.7%
EXISTING HOME PRICE
$ 78,000
10.9%
MORTGAGE RATE
10.7%
1%
4% 5% 6% 7% 8% 9% 10% 11% 12%
ANNUAL PERCENTAGE



PAYMENTS UNDER GPM AND STANDARD MORTGAGE

95TH CONGRESS
1ST SESSION

S. 664

IN THE SENATE OF THE UNITED STATES

FEBRUARY 10 (legislative day, FEBRUARY 1), 1977

Mr. BROOKE (for himself, Mr. ABOUREZK, Mr. ALLEN, Mr. ANDERSON, Mr. BUMPERS, Mr. CASE, Mr. DECONCINI, Mr. EAGLETON, Mr. GRAVEL, Mr. HATFIELD, Mr. HEINZ, Mr. JAVITS, Mr. LEAHY, Mr. MCGOVERN, Mr. MCINTYRE, Mr. MATHIAS, Mr. PEARSON, Mr. SPARKMAN, and Mr. TOWER) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing and Urban Affairs.

A BILL

To amend the National Housing Act to provide for the insurance of graduated payment mortgages, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Young Families' Housing Act of 1977".

GRADUATED PAYMENT MORTGAGES

SEC. 2. (a) This section may be cited as the "Graduated Payment Mortgage Insurance Act".

(b) (1) The caption of section 245 of the National Housing Act is amended to read as follows:

"GRADUATED PAYMENT MORTGAGES".

(2) Section 245 of such Act is amended—

(A) by inserting "(a)" after "SEC. 245.";

(B) by striking out "on an experimental basis" in the first sentence;

(C) by striking out the second sentence and inserting in lieu thereof the following: "Notwithstanding any other provision of this title, the outstanding principal balance of a mortgage or loan insured pursuant to this section may not at any time exceed (1) 97 per centum of the appraised value of the property covered by the mortgage determined as of the date the mortgage is accepted for insurance, or (2) if the mortgagor is a veteran and the mortgage is to be insured in accordance with the provisions of section 203 of this title, such higher percentage of appraised value as is provided for purposes of determining the maximum mortgage amount eligible for insurance under section 203(b)(2) in the case of veterans."; and

(D) by adding at the end thereof the following:

"(b) To be eligible for insurance under this section, a mortgage or loan shall—

"(1) be executed by a mortgagor or borrower who shall have paid on account of the property at least 10

per centum of the Secretary's estimate of the cost of acquisition in cash or its equivalent;

"(2) have a maturity not to exceed thirty years; and

"(3) meet the requirements of section 203 (b) of this title for insurance, except as such requirements are specifically modified by the provisions of this section.

"(c) Any mortgage or loan insured pursuant to this section which contains or sets forth any graduated mortgage provisions (including but not limited to provisions for adding deferred interest to principal) which are approved under this section and applicable regulations, shall not be subject to any State constitution, statute, court decree, common law, or rule of public policy limiting the amount of interest which may be charged, taken, received, or reserved, or the manner of calculating such interest (including but not limited to prohibitions against the charging of interest on interest), if such statute, court decree, common law, or rule would not apply to the mortgage or loan in the absence of such graduated payment mortgage provisions.".

INDIVIDUAL HOUSING ACCOUNTS

SEC. 3. (a) SHORT TITLE.—This section may be cited as the "Individual Housing Account Act".

88-114 O - 77 - 4

(b) ALLOWANCE OF DEDUCTION.—

(1) IN GENERAL.—Part VII of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to additional itemized deductions for individuals) is amended by redesignating section 221 as 222 and by inserting after section 220 the following new section:

"SEC. 221. INDIVIDUAL HOUSING ACCOUNTS.

"(a) DEDUCTION ALLOWED.—In the case of an individual, there is allowed as a deduction amounts paid in cash during the taxable year by such individual to an individual housing account.

"(b) LIMITATIONS.—

"(1) MAXIMUM ANNUAL DEDUCTION.—The amount allowable as a deduction under subsection (a) to an individual for any taxable year may not exceed $2,500. In the case of a married couple filing separate returns, the sum of the amounts allowable to each of them under subsection (a) for the taxable year may not exceed such amount.

"(2) MAXIMUM LIFETIME DEDUCTION.—The amount allowable as a deduction under subsection (a) to an individual for all taxable years may not exceed $10,000. In the case of a married individual, the $10,000 amount in the preceding sentence shall be reduced

by an amount equal to the sum of the amounts allowed as deductions for all taxable years to his spouse.

"(c) DEFINITIONS AND SPECIAL RULES.—

"(1) INDIVIDUAL HOUSING ACCOUNT.—For purposes of this section, the term 'individual housing account' means a trust created or organized in the United States for the exclusive benefit of an individual, or in the case of a married individual, for the exclusive benefit of the individual and his spouse jointly, but only if the written governing instrument creating the trust meets the following requirements:

"(A) No contribution will be accepted unless it is in cash, and contributions will not be accepted for the taxable year in excess of $2,500 on behalf of any individual or in excess of $10,000 on behalf of an individual for all taxable years.

"(B) The trustee is a bank (as defined in section 401(d)(1)) or another person who demonstrates to the satisfaction of the Secretary that the manner in which that person will administer the trust will be consistent with the requirements of this section.

"(C) No part of the trust funds will be invested in life insurance contracts.

"(D) The interest of an individual and the balance in his account is nonforfeitable.

"(E) The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund.

"(F) The entire interest of an individual or married couple for whose benefit the trust is maintained will be distributed to him, or them, not later than 120 months after the date on which the first contribution is made to the trust.

"(d) TAX TREATMENT OF DISTRIBUTIONS.—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, any amount paid or distributed out of an individual housing account shall be included in gross income by the payee or distributee for the taxable year in which the payment or distribution is received, unless such amount is used exclusively in connection with the purchase of a principal residence for the payee or distributee. The basis of any person in such an account is zero.

"(2) EXCESS CONTRIBUTIONS RETURNED BEFORE DUE DATE OF RETURN.—Paragraph (1) does not apply to the distribution of any contribution paid during a taxable year to an individual housing account to the extent that such contribution exceeds the amount allowable as a deduction under subsection (a) if—

"(A) such distribution is received on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year,

"(B) no deduction is allowed under subsection (a) with respect to such excess contribution, and

"(C) such distribution is accompanied by the amount of net income attributable to such excess contribution.

Any net income described in subparagraph (C) shall be included in the gross income of the individual for the taxable year in which it is received.

"(3) TRANSFER OF ACCOUNT INCIDENT TO DIVORCE.—The transfer of an individual's interest in an individual housing account to his former spouse under a divorce decree or under a written instrument incident to a divorce is not to be considered a taxable transfer made by such individual notwithstanding any other provision of this subtitle, and such interest, at the time of the transfer, is to be treated as an individual housing account of the spouse, and not of such individual. After the transfer, the account is to be treated, for purposes of this subtitle, as maintained for the benefit of the spouse.

"(e) TAX TREATMENT OF ACCOUNTS.—

"(1) EXEMPTION FROM TAX.—Any individual housing account is exempt from taxation under this

subtitle unless such account has ceased to be an individual housing account by reason of paragraph (2) or (3). Notwithstanding the preceding sentence, any such account is subject to the taxes imposed by section 511 (relating to imposition of tax on unrelated business income of charitable, etc., organizations).

"(2) LOSS OF EXEMPTION OF ACCOUNT WHERE INDIVIDUAL ENGAGES IN PROHIBITED TRANSACTION.—

"(A) IN GENERAL.—If, during any taxable year of the individual for whose benefit an individual housing account is established, that individual engages in any transaction prohibited by section 4975 with respect to the account, the account ceases to be an individual housing account as of the first day of that taxable year. For purposes of this subparagraph the individual for whose benefit any account was established is treated as the creator of the account.

"(B) ACCOUNT TREATED AS DISTRIBUTING ALL ITS ASSETS.—In any case in which any account ceases to be an individual housing account by reason of subparagraph (A) on the first day of any taxable year, paragraph (1) of subsection (d) applies as if there were a distribution on such first day in an amount equal to the fair market

value (on such first day) of all assets in the account (on such first day).

"(3) EFFECT OF PLEDGING ACCOUNT AS SECURITY.—If, during any taxable year, the individual for whose benefit an individual housing account is established uses the account or any portion thereof as security for a loan, the portion so used is treated as distributed to that individual.

"(f) ADDITIONAL TAX ON CERTAIN AMOUNTS INCLUDED IN GROSS INCOME.—

"(1) DISTRIBUTION NOT USED TO PURCHASE RESIDENCE.—If a distribution from an individual housing account to an individual for whose benefit such account was established is made, and not used in connection with the purchase of a principal residence for such individual, the tax liability of such individual under this chapter for the taxable year in which such distribution is received shall be increased by an amount equal to 10 percent of the amount of the distribution which is includable in his gross income for such taxable year.

"(2) DISQUALIFICATION CASES.—If an amount is includable in the gross income of an individual for a taxable year under subsection (e), his tax under this chapter for such taxable year shall be increased by an amount

equal to 10 percent of such amount required to be included in his gross income.

"(3) DISABILITY CASES.—Paragraphs (1) and (2) do not apply if the payment or distribution is attributable to the taxpayer becoming disabled within the meaning of section 72(m)(7).

"(g) COMMUNITY PROPERTY LAWS.—This section shall be applied without regard to any community property laws.

"(h) CUSTODIAL ACCOUNTS.—For purposes of this section, a custodial account shall be treated as a trust if the assets of such account are held by a bank (as defined in section 401(d)(1)) or another person who demonstrates, to the satisfaction of the Secretary, that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact that it is not a trust, constitute an individual housing account described in subsection (c). For purposes of this title, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof.

"(i) REPORTS.—The trustee of an individual housing account shall make such reports regarding such account to the Secretary and to the individual for whom the account is maintained with respect to contributions, distributions, and

such other matters as the Secretary may require under regulations. The reports required by this subsection shall be filed at such time and in such manner and furnished to such individuals at such time and in such manner as may be required by those regulations.

"(j) REDUCTION OF BASIS.—The basis of any residence acquired with funds withdrawn from an individual housing account shall be reduced by an amount equal to the amount of expenditures made in connection with the acquisition of the residence out of such funds.".

(2) DEDUCTION ALLOWED IN ARRIVING AT ADJUSTED GROSS INCOME.—Paragraph (10) of section 62 of such Code (relating to retirement savings) is amended—

(A) by inserting "or housing" after "Retirement" in the caption of such paragraph, and

(B) by inserting before the period at the end thereof the following: "and the deduction allowed by section 221 (relating to deduction of certain payments to individual housing accounts)".

(c) TAX ON EXCESS CONTRIBUTIONS.—Section 4973 of such Code (relating to tax on excess contributions to individual retirement accounts, certain section 403(b) contracts, certain individual retirement annuities, and certain retirement bonds) is amended—

(1) by inserting "INDIVIDUAL HOUSING ACCOUNTS," after "ACCOUNTS," in the caption of such section,

(2) by redesignating paragraphs (2) and (3) of subsection (a) as (3) and (4), and by inserting after paragraph (1) the following:

"(2) an individual housing account (within the meaning of section 221 (c)),", and

(3) by adding at the end thereof the following new subsection:

"(d) EXCESS CONTRIBUTIONS TO INDIVIDUAL HOUSING ACCOUNTS.—For purposes of this section, in the case of an individual housing account, the term 'excess contributions' means the amount by which the amount contributed for the taxable year to the account exceeds the amount allowable as a reduction under section 221 (b) (1) for such taxable year. For purposes of this subsection, any contribution which is distributed out of the individual housing account and a distribution to which section 221 (d) (2) applies shall be treated as an amount not contributed.".

(d) TAX ON PROHIBITED TRANSACTIONS.—Section 4975 of such Code (relating to prohibited transactions) is amended—

(1) by adding at the end of subsection (c) the following new paragraph:

"(4) Special rule for individual housing accounts.—An individual for whose benefit an individual housing account is established shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if, with respect to such transaction, the account ceases to be an individual housing account by reason of the application of section 221 (e) (2) (A) or if section 221 (e) (4) applies to such account.", and

(2) by inserting "or an individual housing account described in section 221 (c)" in subsection (e) (1) after "described in section 408 (a)".

(e) Failure To Provide Reports on Individual Housing Accounts.—Section 6693 of such Code (relating to failure to provide reports on individual retirement account or annuities) is amended—

(1) by inserting "or individual housing accounts" after "annuities" in the caption of such section, and

(2) by adding at the end of subsection (a) the following: "The person required by section 221 (i) to file a report regarding an individual housing account at the time and in the manner required by such section

shall pay a penalty of $10 for each failure unless it is shown that such failure is due to reasonable cause.".

(f) ADJUSTMENT OF BASIS OF RESIDENCE PURCHASED THROUGH USE OF AMOUNTS IN ACCOUNT.—Section 1016(a) of such Code (relating to adjustments to basis) is amended by inserting after paragraph (20) the following new paragraph:

"(21) in the case of a residence the acquisition of which was made in whole or in part with funds from an individual housing account, to the extent provided in section 221(j);".

(g) CLERICAL AMENDMENTS.—

(1) The table of sections for part VII of subchapter B of chapter 1 of such Code is amended by striking out the item relating to section 221 and inserting in lieu thereof the following:

"Sec. 221. Individual housing accounts.
"Sec. 222. Cross references.".

(2) The table of sections for chapter 43 of such Code is amended by striking out the item relating to section 4973 and inserting in lieu thereof the following:

"Sec. 4973. Tax on excess contributions to individual retirement accounts, individual housing accounts, certain 403(b) contracts, certain individual retirement annuities, and certain retirement bonds.".

(3) The table of sections for subchapter B of chapter 68 of such Code is amended by striking out the item relating to section 6693 and inserting in lieu thereof the following:

"Sec. 6693. Failure to provide reports on individual retirement accounts or annuities or on individual housing accounts.".

(h) EFFECTIVE DATE.—The amendments made by this section apply to taxable years beginning after December 31, 1976.

95TH CONGRESS
1ST SESSION

S. 1078

IN THE SENATE OF THE UNITED STATES

MARCH 22 (legislative day, FEBRUARY 21), 1977

Mr. PROXMIRE (for himself and Mr. BROOKE) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

A BILL

To amend section 245 of the National Housing Act to revise the experimental mortgage insurance program.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 245 of the National Housing Act is amended—

(1) by striking out "on an experimental basis" in the first sentence;

(2) by striking out the second sentence and inserting in lieu thereof a new sentence reading as follows: "Notwithstanding any other provision of this title, the principal obligation (including any interest which may be deferred and added to principal) of a mortgage in-

sured pursuant to this section may not at any time exceed 97 per centum of the appraised value of the property covered by the mortgage determined as of the date the mortgage is accepted for insurance, or, if the mortgagor is a veteran and the mortgage is to be insured in accordance with the provisions of section 203 of this title, such higher percentage of appraised value as is provided for purposes of determining the maximum mortgage amount eligible for insurance under section 203 (b) (2) in the case of veterans."; and

(3) by adding at the end thereof the following new sentence: "Any mortgage or loan insured pursuant to this section which contains or sets forth any graduated mortgage provisions (including but not limited to provisions for adding deferred interest to principal) which are authorized under this section and applicable regulations, or which have been insured on the basis of their being so authorized, shall not be subject to any State constitution, statute, court decree, common law, or rule or public policy limiting the amount of interest which may be charged, taken, received or reserved, or the manner of calculating such interest (including but not limited to prohibtions against the charging of interest

on interest), if such constitution, statute, court decree, common law, or rule would not apply to the mortgage or loan in the absence of such graduated payment mortgage provisions.".

The CHAIRMAN. Our next witnesses consist of a panel including Dr. Saul B. Klaman, executive vice president, National Association of Mutual Savings Banks; David L. Smith, vice president and chief economist, Glendale Federal Savings & Loan Association, Glendale, Calif., representing The National Savings and Loan League; John U. Raymond, president and chairman of the board, Home Federal Savings and Loan Association, Washington, D.C., representing The U.S. League of Savings Associations; and Robert W. Irving, senior vice president, Equitable Trust Co., Baltimore, Md., representing the American Bankers Association.

This is a most impressive panel. Gentlemen, I'm going to have to step out of the room just a minute and Senator Sparkman will be in charge. I will be back in 3 or 4 minutes.

Senator SPARKMAN. Dr. Klaman, your name comes first on the list, so we will be glad to hear from you.

STATEMENT OF DR. SAUL B. KLAMAN, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

Dr. KLAMAN. Thank you very much, Senator Sparkman. I was going to say it's a pleasure to appear again before the Chairman but he has just prevented me from saying that, but I'll say it anyway, and especially appearing before Senator Brooke and Senator Sparkman. We have had these meetings before and I look forward to this one.

In the interest of time I'm going to try to summarize my statement in 5 or 6 minutes because I know you want to ask questions and I'm going to try to get the major points across.

I can't resist commenting for the first 30 seconds of that time on Professor Rosen's projections. I have known Professor Jaffe and Professor Rosen well and I have the profoundest respect for them, but I think we have to be very careful in making projections of 7 percent inflation for the rest of the decade—for the next 10 years, with average housing prices looking at us of $86,000. Econometric projections serve their purpose, but they have never been particularly accurate in forecasting housing activity for even 1 year, let alone 10 years ahead. I would say, in all due respect, that if we have nothing better than that to look forward to—a 7-percent rate of inflation—we have far deeper problems confronting us in this country than housing and I really am quite concerned about that kind of a forecast.

I think we ought to start from that basis and examine the issues on their merits today. If we need this kind of program we need it today to meet the housing problems of young families now and hopefully not base a major program on what may happen 10 years from now.

[Complete statement follows:]

88-114 O - 77 - 5

Statement of the
National Association of Mutual Savings Banks
before the
Committee on Banking, Housing and Urban Affairs
The United States Senate
on
S. 664 and S. 1078
March 31, 1977

Mr. Chairman and Members of the Committee, my name is Saul B. Klaman. I am executive vice president of the National Association of Mutual Savings Banks. I am accompanied today by Louis H. Nevins, director-counsel, and Franklin L. Wright, assistant director and housing counsel, of our Washington office.

We welcome this opportunity to appear before you to present our views on S. 1078, a bill to amend section 245 of the National Housing Act to revise the experimental mortgage insurance program, and S. 664, the Young Families' Housing Act of 1977. As you recall, our association appeared before the Housing Subcommittee last August and presented testimony on the Young Families' Housing Act of 1976.

Our testimony at that time was presented in an unfavorable housing environment of high interest rates, rising home prices, accelerating costs of home maintenance, and increasing utility expenses. These expenses were combining to keep an increasing percentage of American families -- probably the bulk of those families with incomes of less than $20,000 -- from achieving the goal of home ownership. In our testimony, we applauded Senator Brooke's proposal as an innovative attempt to widen home ownership opportunities for moderate- and middle-income families, but expressed reservations regarding aspects of the proposal.

Now approximately seven months later, we appear before this Committee on a similar issue. Unfortunately, the conditions contributing to the housing affordability problems of last summer have not abated. Rather, they have been exacerbated. Housing prices have continued to soar, interest rates have remained relatively high, and maintenance, heating, and utility expenses have risen.

The Young Families' Housing Act of 1977 would, as we understand it, assist families seeking to buy homes in two ways. First, the bill would modify and expand the existing experimental authority of the Department of Housing and Urban Development to insure graduated payment mortgages. S. 1078 would similarly modify and expand this authority. Second, S. 664 would provide for a new type of tax exempt savings account. Patterned after the Individual Retirement Account, the Individual Housing Account authorized by this bill would assist first-time homebuyers in accumulating funds for a downpayment. The Individual Housing Account would permit families to exempt from federal income taxation up to $10,000 over a 10-year period provided the funds are used for the purchase of a home. Provision is made for recapture of the lost tax revenue. Recapture would be accomplished by reducing the basis of the home at the time of sale by the amount of the downpayment which derived from an IHA.

In our testimony last August, the savings bank industry strongly endorsed the IHA proposal and the present proposal similarly merits our strong support. Such accounts would aid families in accumulating downpayments. Moreover, the recapture provision should diminish the budgetary impact of the legislation.

The savings bank industry favors consideration of, and experimentation with, new mortgage loan contracts such as graduated payment mortgages. Last summer, we commented on the Department of Housing and Urban Development's program for graduated payment mortgages and were gratified that the final regulations reflected certain of our suggestions. But despite these significant improvements, we continue to have reservations as to how widespread lender acceptance of such mortgages will be.

First, utilization of a graduated payment mortgage entails a reduced cash flow and increased risk in the early years, as compared with the traditional level-payment mortgage. Thus, the volume of funds available for additional lending or to meet liquidity needs could be diminished. We do note that the 10 percent downpayment required by the Young Families' Housing Act would tend to lessen the lender's increased risk.

Second, originating and servicing costs are likely to be higher with the graduated payment mortgages. A graduated payment mortgage will be difficult to explain to borrowers, many of whom will be slow to grasp all of its ramifications. The additional time and effort to provide the explanations will necessarily add to the origination costs. Servicing costs will similarly increase because of the annual changes in monthly payments together with the required statements and explanations to the borrower.

Notwithstanding careful explanations at the inception of the loan, we foresee customer relations problems when borrowers see mortgage balances continuing to rise in the early years even though monthly payments are made on time. While there really can be no compensation for these kinds of difficulties, authorization of HUD to allow both originating and servicing fees somewhat higher than those permitted under FHA mortgage insurance programs would compensate for the time required to minimize the problem.

Further, the use of alternative mortgage instruments should not be restricted solely to graduated payment mortgages. Rather, we must begin to develop mortgage instrumente that accommodate the needs of both borrowers and lenders. Development of such instruments necessarily should include experimentation with a variety of such instruments including those utilizing a variable rate mechanism. The variable rate mortgage has been criticized

by some as being unfair to the borrower -- that the lender is in a much better position to take market rate risks than the lender. Such criticism assumes that market interest rates go only up. Experience instructs us to the contrary as witness the decline in rates from the peaks of 1973 and 1974. Moreover, it should be recognized that variable rate mortgages are not infrequently offered at rates lower than those being offered in conjunction with the traditional loan instrument. Finally, it must be noted that the current system clearly penalizes new borrowers by requiring them to pay a rate reflecting an inflation premium. This premium is included to compensate lenders holding portfolios of loans made at rates well below current levels. Moreover, lenders because they know they will be unable to adjust rates in the future, include a hedge against future inflation.

All things considered, we are convinced that both borrowers and lenders would benefit if alternatives to the long-term, fixed rate mortgage were available in the market place. Accordingly, we strongly urge the Committee to consider and to adopt an amendment which would authorize HUD, under the Section 245 Experimental Financing program, to experiment with other kinds of alternative mortgage instruments as well, including the authority to experiment with both variable rate and stepped-rate mortgages.

Despite the negative reaction of certain groups to variable rate mortgages, consumers have accepted them in the marketplace. The California experience is well documented. However, less well known is the experience of Washington Mutual Savings Bank of Seattle. The bank's plan, which is designed to expand home ownership opportunities for younger families -- interestingly enough the same objective that S. 664 seeks to achieve -- is a multi-level rate plan. The program, which has been overwhelmingly

appealing in Washington, offers in the early years of a loan interest rates well below the current market rate being offered on level-payment mortgages. At intervals of two years, there are increases in the loan's rate of interest. Beginning at the end of the sixth year, the rate is fixed at a level slightly above current market levels. The rate schedule for the entire term of the loan is clearly spelled out in the mortgage contract at its inception so there are no surprises and no questions about future fluctuations in interest rates. This plan, like the GPM, thus permits younger families to take advantage of future earnings increases.

In conclusion, we are pleased with the fact that the Committee is considering these bills and beginning to examine some of the problems inherent in the traditional level-payment mortgage instrument. We hope that the Committee will consider expanding the Section 245 Experimental Financing program to permit HUD to experiment with a wide variety of mortgage instruments.

The Committee is undoubtedly aware that mutual savings banks in most states are now permitted to offer variable rate mortgages. Thus, while adoption of our suggested amendment is not strictly necessary for the savings bank industry, it would promote experimentation with alternative instruments in both conventional, as well as FHA loans. Such experimentation will redown to the benefit of all those who are interested in expanding home ownership opportunities.

Finally, we would note that when this Committee first voted to create the Section 245 program, provision was made to permit HUD to experiment with variable rate mortgages as well. While this particular provision was dropped in conference, it is important to realize that we are asking the Committee only to readopt the same position it took a few years ago.

We appreciate this opportunity to share thoughts with you and hope that they will be helpful as the Committee continues its deliberations.

The CHAIRMAN. Thank you very much.

Senator BROOKE. Could we have all the statements before we ask questions?

The CHAIRMAN. Yes, indeed, and all the statements will be printed in full in the record.

Senator BROOKE. I just want to say to Dr. Klaman, this is not a defense of Dr. Rosen, because as you know he can ably defend himself, but when you mentioned about the projections of 7 percent inflation for the next 5 or 10 years, we all agree and I think Dr. Rosen said he agreed or hoped that that would not be the case. I just want to point out to you for the last 5 years we have had an average of 7-percent inflation rate and I think that's probably colored some of Dr. Rosen's thinking about it. Let us hope and pray that we won't be exposed to that for the next 5 or 10 years.

The CHAIRMAN. One thing we can be sure of and that is nobody can predict it. We just don't know. The economists were so sure in 1974 that the inflation rate would be 2 or 3 percent and it was 12 percent. If you can't predict for 1 year you certainly can't predict for 10 years.

Dr. KLAMAN. My title no longer includes the words "Chief Economist." I just gave up on that one.

Senator BROOKE. When did you give that up?

Dr. KLAMAN. They kicked me upstairs. When the headlines of this hearing are printed, though, the real catchword is going to be that "Professor so-and-so from so-and-so university forecast an average housing price of $85,000" and it's going to scare people. Another focal point will be that of a $20,000 downpayment, and I don't think either of these are the basis of this legislation. It's needed now perhaps because of the current environment and let's leave it that way.

Senator BROOKE. But we already have the Harvard-MIT headlines that came out, as you very well know, which predicted $78,000, and scared the life out of all of us. I'm not setting Princeton against Harvard and MIT, but still, I think we can expect that the cost of housing is going to be considerably higher.

The CHAIRMAN. I agree with Senator Brooke. We have to move ahead. It's already 10 minutes to 12 and we have a number of other witnesses.

STATEMENT OF DAVID L. SMITH, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, GLENDALE FEDERAL SAVINGS & LOAN ASSOCIATION, GLENDALE, CALIF., ON BEHALF OF THE NATIONAL SAVINGS AND LOAN LEAGUE

Mr. SMITH. Thank you very much. Due to the lateness of the hour, I'd like to very briefly summarize my statement.

When we sat down and tried to explain these GPM's to the borrowers, the overwhelming reaction was negative. They did not like that kind of concept, until we showed them the two tables that are in my statement that detailed the exact dollar and cent monthly payments for the full term of the loan and the actual outstanding balance at the end of each year of the loan.

When the people saw the dollars and cents involved, the overwhelming negative response turned almost immediately to an overwhelming positive response and virtually every person we talked to indicated that if they had the free choice they would choose a GPM over a standard loan. The brochure that is part of the statement is what we now give all prospective inquirers about this instrument. The two tables on outstanding balances and monthly payments are given to every borrower for his loan so he can see the exact dollar and cent obligation he will incur at any point in time for the full term of the loan. This explanation process we have gone through has made it much easier for both our people and, more importantly, the borrower to understand his obligation under the mortgage contract.

Senator SPARKMAN. Thank you, Mr. Smith. Let me say there's a rollcall on and Senator Proxmire has already left. It's limited to 15 minutes so Senator Brooke and I must also go.

Senator BROOKE. I will stay, Mr. Chairman.

[Complete statement of Mr. Smith follows:]

Statement of David L. Smith

Senior Vice President & Chief Economist
Glendale Federal Savings & Loan Association
Glendale, California

on behalf of the
National Savings and Loan League

before the
Committee on Banking, Housing and Urban Affairs
United States Senate

Hearings on S. 664 and S. 1078
Washington, D. C.
March 31, 1977

Mr. Chairman and Members of the Committee:

I am honored to have this opportunity to appear before you today. My name is David L. Smith. I am Senior Vice President and Chief Economist of Glendale Federal Savings and Loan Association, Glendale, California. I am representing the National Savings and Loan League, which is a nationwide trade organization for savings and loan associations.

The National Savings and Loan League wholeheartedly endorses the graduated payment mortgage provision of Senate Bills 664 and 1078 and strongly urges this Committee to enact this provision as the first step in a broad reform in home financing techniques. The membership of the National Savings and Loan League adopted a resolution at its annual convention last October calling for the creation of several new types of home mortgage instruments, one of which was the graduated payment mortgage.

GRADUATED PAYMENT MORTGAGES

Both S. 664 and S. 1078 would amend Section 245 of the National Housing Act to remove the present volume restrictions on the experimental program with FHA insured graduated payment mortgages. Under S. 664, FHA would be able to insure graduated payment mortgages where:

a. the maximum loan balance does not exceed 97% of the original appraised value (veterans may qualify for a larger amount);

b. the maximum term is 30 years;

c. the borrower's down payment is at least 10% of the acquisition cost of the property; and

d. the mortgage would be exempt from any state-imposed interest rate restrictions.

The Graduated Payment Mortgage

The graduated payment mortgage (GPM) directly attacks one of the major defects of the standard fixed payment mortgage -- that the amount of house a family can afford depends upon its income at the time the house is purchased even though they may live in the house for many years. In effect, the GPM simply "tilts" the mortgage payment stream so that it more closely corresponds to a typical family's income growth over a period of years.

The major differences between a graduated payment mortgage and a standard level-payment mortgage are that:

1. the payments rise over time, rather than remaining fixed for the life of the loan; and

2. in the early years, the payments are not sufficient to cover the interest owed so that the loan balance increases for the first few years.

Charts 1 and 2 compare the monthly payment and outstanding balance for two versions of the FHA graduated payment mortgage with a standard FHA level-payment mortgage. As shown in Chart 1, the monthly principal and interest payment for a $40,000 loan at 8% interest would be $294 for a standard FHA mortgage. With a graduated payment mortgage where the payments rise 7.5% for five years and then remain flat for the remaining term (FHA Plan III), the monthly payments for the same mortgage would start at $220 -- 25% below the standard mortgage -- and rise by about $17 each year until they reached $316 a month in the sixth year. Under FHA Plan V, the payments would rise 3% each year for 10 years and remain flat for the remaining term. In this case, the monthly payments would start at $242 and rise by about $8 each year until they reached $326 in the eleventh year. It should be noted that eight years elapse before the payments on this version of the GPM even match what they would have been on a standard loan.

The primary advantage of the graduated payment mortgage is the simple fact that it enables families to purchase a home that they would not have been able to afford with a standard level payment mortgage -- provided that they have good reason to expect their income to grow in the future. Thus, the graduated payment mortgage is particularly suited to young families buying their first home.

The major drawback of the GPM is the negative amortization aspect. For the past forty years, both borrowers and lenders have been conditioned to expect the loan balance to decline with each payment. Borrowers will have to be taught that they could owe the lender more than they originally borrowed if they sell the house in the first few years of the loan. Lenders will have to learn how to handle the reduced cash flow in the early years and how to evaluate their risk on a loan where the outstanding balance rises for a period of time. I believe that these problems can be overcome with proper education. However, the additional risk and costs associated with graduated payment mortgages mean that GPM loans should carry a higher interest rate than standard mortgages. Until such time as experience proves otherwise, I estimate that non-insured GPM loans should have an interest rate 25 basis points above the rate on standard loans.

A Smorgasbord of Mortgage Instruments

Widespread use of graduated payment mortgages (both FHA insured and conventional) would, in my opinion, go a long way to solve many of the problems faced by young families in today's housing market. However, no one mortgage instrument can hope to deal adequately with the diverse needs of the wide range of homebuyers. Therefore, I believe that the best solution is to create a wide variety of mortgage instruments so that potential mortgage borrowers can choose the mortgage design that best fits their particular needs and expectations.

The Federal Home Loan Bank Board is currently studying a wide variety of mortgage designs. Hopefully, this Committee will encourage the Bank Board to proceed with regulations authorizing Federal S&Ls to offer the consumer a choice between several home mortgage financing techniques.

The Present FHA Experiment

Last fall, the Department of Housing and Urban Development issued regulations for an experimental program with FHA insured graduated payment mortgages.[1] Given the limitation that only about 2,500 GPMs would be insured by FHA, HUD established a reservation procedure so that individual lenders would know how many loans they could originate.

In my opinion, this volume restriction is unnecessary and it severely limits the usefulness of the "experiment". The problems caused by the volume restriction include:

1. the small number of loans granted to any one lender precludes any meaningful advertising of the loans;

2. the loans have to be processed and serviced manually, rather than by computer;

---

1 The program is limited to one percent of the outstanding aggregate principal amount of all mortgages and loans insured in any one year under Title II of the National Housing Act.

3. employee training and education costs are very high;

4. in most cases, lenders are not able to utilize the loans for new construction projects, but are restricted to using them for spot lending on resales of existing homes; and

5. the number of loans is too small to obtain any meaningful data on the borrowers.

The best way to "experiment" with graduated payment mortgages is to remove all volume restrictions -- as proposed in S. 664 and S. 1078 -- and let borrowers choose between standard mortgages and readily available graduated payment mortgages. A viable marketplace for graduated payment mortgages can only be created when:

1. lenders conduct meaningful marketing and public education programs;

2. the lending community itself learns how to deal with GPMs, including the development of proper computer processing; and

3. a secondary market is developed.

Glendale Federal's Experience

Wilshire Mortgage Corporation, a wholly owned subsidiary of Glendale Federal Savings, received a reservation for 50 of the FHA graduated payment mortgages. Wilshire Mortgage acts as a mortgage banker for Glendale Federal, specializing in the origination of FHA and VA loans which are then sold in the secondary market. Wilshire Mortgage usually services the loans for the purchaser.

A brochure describing the GPM program, together with an example, was prepared for distribution to real estate brokers and the public (see Exhibit A). In addition, payment and amortization schedules were developed for all authorized loan amounts at the current FHA rate of 8 percent. These schedules permit the loan officer to provide the

borrower with a detail of the payment and loan balances for each year of the GPM and are used to assist the borrower to select a plan suited to his particular situation.

Glendale Federal and Wilshire Mortgage deliberately restricted the GPM to first-time homebuyers in the spirit of the original intention of the GPM experiment. To date, the marketing program has been very low-key and has consisted only of contacting real estate brokers in selected areas of Southern California. These real estate brokers were asked to describe the GPM program to potential buyers and refer them to Wilshire Mortgage for additional information about the program. No mass media advertising has been conducted due to the small number of GPM loans authorized. Thus, only those people already in the market for a home in selected geographical areas are even aware of the program.

Wilshire Mortgage's GPM program became effective February 7, 1977. As of March 23, only seven GPM loans had been applied for (four more applications are in the initial stages). The loan officers tell me that all 50 GPM loans could have been issued in the first four weeks of the program if the first-time homebuyer restriction were removed so that any potential FHA borrower could apply.

Table 1 provides a profile of the seven applicants for the graduated payment mortgages, together with a profile of ten randomly selected standard FHA loan applications in process at Wilshire Mortgage on March 23, 1977.

The average GPM loan applicant is 29 years old, has an annual income of $15,805, is buying a home selling at $38,785, with a down payment of $3,171. The average loan amount is $35,614 and the average monthly payment for principal, interest, taxes and insurance is $286. Thus, the average GPM applicant has a payment-to-income ratio of 22.4 percent, where the high is 30.2 percent and the low is 17.3 percent. Six applicants selected Plan III (7.5 percent payment increases for five years) and one selected Plan I (2.5 percent payment increases for five years). If these seven borrowers had all used the standard FHA mortgage, their average initial monthly payment would have been $60 higher, and the payment-to-income ratio would have averaged 27.0 percent, rather than

22.4 percent. In the case of Borrower No. 2, the GPM probably meant the difference in enabling him to purchase the home, as the GPM reduced the initial monthly payment from $341 to $278. Instead of having a payment-to-income ratio of 37.1 percent with a standard loan, this borrower has a payment-to-income ratio of 30.2 percent. [2]

The average standard FHA loan applicant was slightly older (32.6 years), had a higher income ($18,008), was buying a slightly less expensive home with a smaller down payment, and had an average loan amount about $900 lower than the average GPM applicant. However, the average monthly payment was $331 -- $45 higher (16 percent) than the average GPM applicant.

Given the extremely small number of loan applicants, care must be taken not to arrive at firm conclusions about GPM borrowers versus standard borrowers -- particularly in view of the fact that all of these people were already trying to buy a home before they ever heard of the graduated payment mortgage.

Glendale Federal's Research

Prior to introducing the GPM program, Glendale Federal conducted some market research to determine possible consumer response to the graduated payment mortgage. In early December, 1976, three panel group interviews were conducted in the Greater Los Angeles Area with a total of 22 persons participating. A profile of the participants in the survey is summarized in Table 2. Panel group interviews are commonly used in market research to identify tentative qualitative responses. It is not possible to quantify the results of a series of panel group interviews.

The overriding conclusion from the interviews was the importance of certainty regarding the borrower's obligation under a mortgage contract.

---

2 Under a standard mortgage, Borrower No. 2 would need an annual income of $13,640 -- 24 percent above his $11,040 income -- to keep the payment-to-income ratio at 30 percent.

The overwhelming response was negative to a mortgage instrument that involved increasing mortgage payments and negative amortization. However, when the two tables shown in Exhibit A were given to the participants, the overall reaction to the graduated payment mortgage became very positive when they could see the actual dollar amounts involved. In fact, only the two people over age 45 indicated that they would not want a GPM if it were available. All other participants indicated that they would select a graduated payment mortgage over a standard level-payment loan -- provided that they knew the payment and amortization schedules in advance.

The reasons offered for selecting a GPM over a standard loan included:

1. the lower initial monthly payments with a GPM would reduce the burden of the mortgage payment in the early years of the loan;

2. the rate of scheduled increases in the monthly payment was small relative to their expected income growth;

3. the amount of negative amortization was small relative to their expectation of increasing home values; and

4. several people indicated that the GPM would enable them to buy the three bedroom home they really wanted, rather than being forced to start with a smaller two bedroom home and buy the larger home later.

<u>Other Problems with FHA Mortgages</u>

The FHA insured graduated payment mortgage program currently suffers from two constraints on all FHA insured loans -- the $45,000 loan limit and the 8 percent interest rate ceiling.

If FHA mortgages are to be viable in the marketplace, I recommend that the $45,000 loan limit (under Section 203b) be raised to at least $60,000, thereby enabling more borrowers to utilize this type of home

financing. For example, house prices in California have risen rapidly in the last five years to the point where the $45,000 limit for FHA loans covers only a very small segment of the market. For example, in February of this year, the average sales price for all homes sold in Orange County, California (new and used) was $73,465! Chart 3 shows how the average new home price in Los Angeles County has risen faster than the national average in the last four years. These rapid price increases have severly limited the FHA marketplace, making it impossible to utilize FHA financing in major sections of the California market.

The FHA interest rate ceiling limits the use of FHA mortgages by financial institutions, as lenders are reluctant to hold FHA loans in their portfolios when the conventional interest rate is significantly higher than the FHA rate. [3]

The FHA interest rate ceiling also distorts housing prices, because the marketplace puts a discount on FHA loans that is presently around five percent. Under present law, these so-called "points" must be absorbed by the seller. However, the sales price of the house is usually inflated by a corresponding amount, so that this cost is passed on to the buyer. [4]

---

3 The relative importance of FHA/VA financing by savings and loan associations has dropped considerably over the past 25 years. In 1950, FHA/VA loans accounted for 28 percent of all mortgage loans held by S&Ls. In 1950, the ratio was 18 percent, in 1972 it was 14 percent, and the ratio fell to 11 percent in 1975. In the three year period from 1972 to 1975, S&L holdings of FHA/VA loans rose only 5.9 percent, compared to a 40 percent jump in conventional loans.

4 As a general rule, sellers attempt to add a premium to the sales price of their house if there is a good chance that the buyer will use FHA, rather than conventional financing. Therefore, the house price is inflated, and the increased cost is passed on to the buyer, who now has a larger loan amount and a higher monthly payment. This phenomena is recognized by the appraisal profession, which attempts to use similar types of financing as the basis for comparable sales prices of other houses in the community.

88-114 O - 77 - 6

The old axiom, "There is no free lunch", is particularly true with respect to FHA financing. Therefore, it would seem to be far more efficient to remove the arbitrary interest rate ceiling on FHA loans and let the rate be determined in the marketplace. At the very least, the FHA ceiling rate should be changed more frequently in an attempt to minimize the discount points.

THE INDIVIDUAL HOUSING ACCOUNT

Senate Bill 664 would also create an "Individual Housing Account" (IHA) designed to help young families accumulate the down payment for a house via income tax incentives. Annual contributions up to $2,500 (total $10,000) would be deductible from taxable income and interest earned on the IHA would be tax free -- provided that the proceeds were applied to the purchase of a home.

The National Savings and Loan League supports the concept of the IHA as an innovative and constructive way to help young families accumulate the down payment for a house. As presently proposed, the income tax savings of the IHA are very substantial. For example, if a family in the 22 percent tax bracket saved the maximum amount, the tax savings would be about $650 a year, or about $2,600 for a four-year program. Including the tax benefits, a family would have to save about $160 a month for a four-year period to accumulate $10,000. My rough personal estimate is that the IHA would cost the Federal government about $650 million per year for each million families that saved the maximum amount. However, the estimate does not take into account the added tax receipts that would flow to the Treasury from the additional business activity that would ultimately be generated as these families purchased homes that they otherwise would not have been able to buy.

Although I personally support the concept of the IHA, I believe that several aspects of the proposal should be changed to reduce the cost of the program to the Federal government. Specifically:

1. The IHA should be limited to first-time homebuyers. As presently proposed, all existing homeowners would be able to establish a tax-subsidized IHA to build a nice nestegg for a subsequent house purchase.

2. The $2,500 maximum annual tax deduction is too high and should be lowered to $1,500. Assuming that the intent of the IHA is to assist young, relatively low-income families accumulate a down payment, the $2,500 appears excessive relative to their income.

3. The maximum lifetime deduction should be reduced from $10,000 to $6,000. Lowering the total deduction to $6,000 would still enable young families to accumulate a 10 percent down payment for a moderately priced home.

The combined effect of these three changes should significantly reduce the cost of IHA to the Federal government, without significantly affecting the ability of the program to assist first-time homebuyers accumulate their down payment.

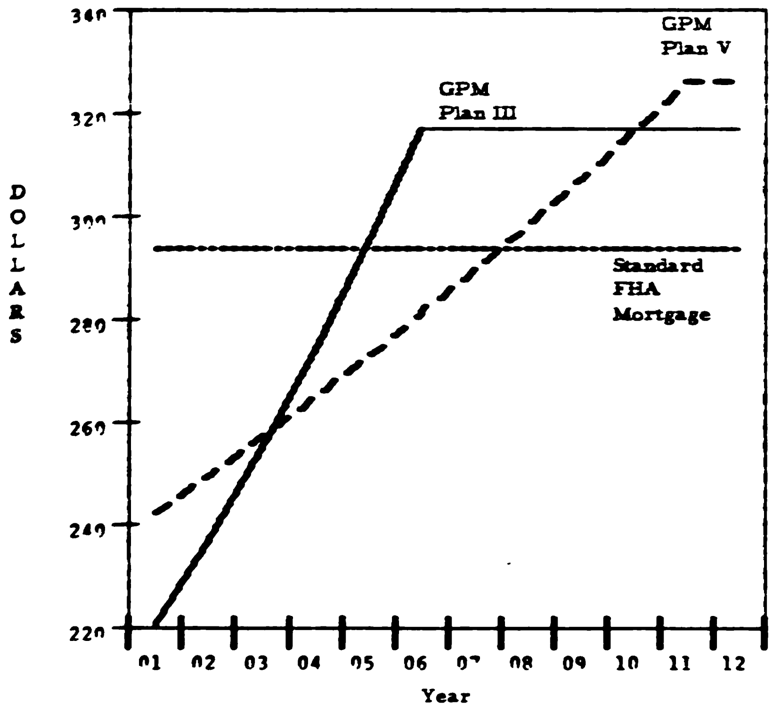
In conclusion, Mr. Chairman, the National Savings and Loan League wholeheartedly endorses the graduated payment mortgage as proposed in S. 664 and S. 1078. The National League also endorses the concept of the Individual Housing Account.

Although the National League has not addressed the following specific points, Glendale Federal Savings and Loan Association recommends that: the FHA loan limit be raised to $60,000; the FHA interest rate ceiling be adjusted more frequently so as to minimize the discount points; the IHA be limited to first-time homebuyers; and the IHA dollar limits be reduced to a $1,500 annual deduction and a $6,000 total deduction.

Thank you for the opportunity to present this testimony.

CHART 1

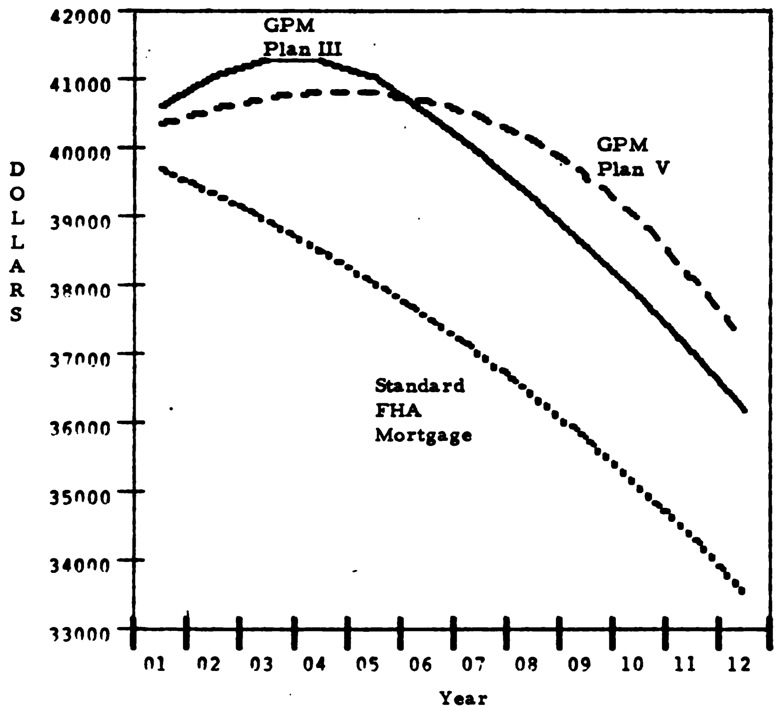
Monthly Payment
$40,000 Loan, 8.00% Interest, 30-Year Term



Glendale Federal Savings
Corporate Planning Dept.
March 1977

CHART 2

Remaining Balance
$40,000 Loan, 8.00% Interest, 30-Year Term



Glendale Federal Savings
Corporate Planning Dept.
March 1977

WILSHIRE MORTGAGE'S NEW GRADUATED PAYMENT MORTGAGE

EXHIBIT A

What is a Graduated Payment Mortgage?

A Graduated Payment Mortgage (GPM) is a new type of mortgage that starts the monthly payment below that of a standard mortgage. At the end of each of the first few years the monthly payments increase by a fixed rate, after which they remain level.

What are the benefits of a GPM?

Because the initial GPM payment is below that of a standard mortgage, more borrowers can qualify for mortgage loans. In addition, the borrower knows exactly what the payments will be in the future.

Who can apply for a GPM?

Any borrower who is currently seeking an FHA insured loan on an owner-occupied single family dwelling can apply for a GPM.

How many GPM plans are offered?

The borrower can select from five different GPM Plans:

- Three plans increase the payments annually for the first five years by 2.5%, 5%, or 7.5%.
- Two plans increase the payments annually for the first 10 years by 2% or 3%.

After either the fifth or tenth year, depending upon the plan selected, the payments remain level.

What would the payments be on a $40,000 mortgage?

Assume an FHA borrower needs a $40,000, 30-year loan and the current FHA mortgage rate is 8%. As shown in Table 1, the borrower can reduce the first year's monthly payments by $27 to $73 with a GPM as opposed to a standard mortgage.

The reduced monthly payments will cause the mortgage balance to increase during the first few years. As shown in Table 2, the maximum balance will be between $1 to $1,238 higher than a standard mortgage.

What about the downpayment?

Downpayments are somewhat higher with a GPM than a standard mortgage. Assuming an acquisition cost of $45,000 and 8% mortgage rate, a GPM would require an additional $50 to $1,250 downpayment, depending upon the plan selected.

If you have any questions, or would like additional information, feel free to call us at (213) 240-4950.

TABLE 1

MONTHLY PAYMENTS
$40000 LOAN, 8.00% INTEREST, 30-YEAR TERM

	FHA GRADUATED PAYMENT MORTGAGE					FHA STANDARD MORTGAGE
NUMBER OF PAYMENT INCREASES	5			10		
GRADUATION RATE	2.5%	5%	7.5%	2%	3%	
YEAR						
1	266.60	242.32	220.40	258.49	242.33	293.51
2	273.27	254.43	236.93	263.66	249.60	293.51
3	280.10	267.15	254.70	268.93	257.09	293.51
4	287.10	280.51	273.81	274.31	264.80	293.51
5	294.28	294.54	294.34	279.79	272.74	293.51
6	301.64	309.26	316.42	285.39	280.93	293.51
7	301.64	309.26	316.42	291.10	289.35	293.51
8	301.64	309.26	316.42	296.92	298.03	293.51
9	301.64	309.26	316.42	302.86	306.98	293.51
10	301.64	309.26	316.42	308.91	316.18	293.51
11	301.64	309.26	316.42	315.09	325.67	293.51
12	301.64	309.26	316.42	315.09	325.67	293.51
13	301.64	309.26	316.42	315.09	325.67	293.51
14	301.64	309.26	316.42	315.09	325.67	293.51
15	301.64	309.26	316.42	315.09	325.67	293.51
16	301.64	309.26	316.42	315.09	325.67	293.51
17	301.64	309.26	316.42	315.09	325.67	293.51
18	301.64	309.26	316.42	315.09	325.67	293.51
19	301.64	309.26	316.42	315.09	325.67	293.51
20	301.64	309.26	316.42	315.09	325.67	293.51
21	301.64	309.26	316.42	315.09	325.67	293.51
22	301.64	309.26	316.42	315.09	325.67	293.51
23	301.64	309.26	316.42	315.09	325.67	293.51
24	301.64	309.26	316.42	315.09	325.67	293.51
25	301.64	309.26	316.42	315.09	325.67	293.51
26	301.64	309.26	316.42	315.09	325.67	293.51
27	301.64	309.26	316.42	315.09	325.67	293.51
28	301.64	309.26	316.42	315.09	325.67	293.51
29	301.64	309.26	316.42	315.09	325.67	293.51
30	301.64	309.26	316.42	315.09	325.67	293.51

TABLE 2

END OF YEAR REMAINING BALANCE
$40000 LOAN, 8.00% INTEREST, 30-YEAR TERM

	FHA GRADUATED PAYMENT MORTGAGE					FHA STANDARD MORTGAGE
NUMBER OF PAYMENT INCREASES	5			10		
GRADUATION RATE	2.5%	5%	7.5%	2%	3%	
YEAR						
1	40000.80	40303.15	40576.98	40101.85	40303.00	39665.86
2	39918.70	40480.63	40860.96	40147.78	40540.64	39303.97
3	39744.72	40514.45	41225.40	40131.88	40704.77	38912.08
4	39469.12	40384.77	41238.22	40047.70	40786.51	38487.82
5	39081.29	40303.71	40896.44	39888.23	40776.13	38027.94
6	38569.68	39646.15	40489.78	39646.86	40663.02	37530.12
7	38916.80	38977.07	39876.83	39312.30	40436.80	36990.97
8	37415.83	38361.83	39240.05	38878.98	40081.23	36407.08
9	36765.66	37686.52	38567.34	38334.93	39596.13	35774.72
10	36061.88	36973.91	37629.03	37670.74	38936.28	35085.86
11	35299.82	36192.40	37029.46	36874.51	38112.32	34348.20
12	34474.13	35346.03	36163.51	36012.18	37221.06	33544.98
13	33580.12	34429.41	35225.69	35076.29	36256.81	32675.05
14	32611.91	33436.72	34210.04	34066.80	35210.45	31732.93
15	31563.34	32361.63	33110.08	32971.53	34078.33	30712.82
16	30427.74	31197.30	31918.83	31786.27	32852.25	29607.53
17	29197.85	29936.34	30628.71	30500.54	31524.30	28410.92
18	27865.96	28570.73	29231.51	29108.19	30086.33	27114.89
19	26423.47	27091.78	27718.34	27602.36	28528.91	25711.29
20	24861.26	25490.04	26079.57	25970.44	26842.23	24191.19
21	23169.39	23755.39	24304.80	24203.09	25015.56	22544.92
22	21337.10	21876.75	22382.71	22289.06	23037.26	20762.01
23	19352.73	19842.19	20301.09	20216.14	20894.77	18831.12
24	17203.65	17638.78	18046.70	17971.19	18574.45	16738.96
25	14876.20	15252.44	15605.20	15538.90	16061.56	14476.25
26	12355.88	12668.07	12961.06	12906.82	13340.06	12022.56
27	9625.74	9869.19	10097.44	10055.19	10392.73	9368.30
28	6669.33	6838.01	6996.16	6966.88	7200.76	6488.57
29	3467.54	3555.24	3637.45	3622.24	3743.83	3374.08
30	-0.00	-0.00	-0.00	-0.00	-0.00	-0.00
MAXIMUM BALANCE	40000.80	40514.45	41238.22	40147.78	40786.51	
MAXIMUM BALANCE ACHIEVED AFTER PAYMENT NUMBER	12	36	40	24	48	

TABLE I

BORROWER PROFILES

FHA Loan Applicants - Wilshire Mortgage Corp. [1]

Applicant	Annual Income	Occupation	Age	No. of Dependents	First Time Buyer	Home	Sales Price	Down Payment	Loan Amount	Monthly Payments[2]	Payment-Income Ratio	GPM Plan
Graduated Payment Mortgages:												
1	$16,020	Factory	29	2	Yes	Used	$35,950	$2,000	$33,950	$284	21.2%	III
2	11,040	Draftsman	22	1	Yes	Used	38,500	4,050	34,450	278	30.2	III
3	14,900	Lab. Asst.	26	0	Yes	Used	37,000	2,800	34,200	280	20.2	III
4	17,125	Realtor Assoc.	30	3	No	Used	44,000	4,350	39,650	323	22.6	III
5	13,630	Carpenter	33	0	Yes	Used	41,600	3,600	38,000	307	27.0	III
6	18,575	Nurse	35	4	Yes	Used	41,950	4,350	37,600	279	18.0	III
7	19,345	Maintenance	27	1	Yes	Used	32,500	1,050	31,450	279	17.3	I
Average	$15,805		29	1.6			$38,785	$3,171	$35,614	$286	22.4%	
Standard Mortgages 203(b):												
8	$26,700	Sales Rep.	46	0	No	Used	$35,500	$1,450	$34,050	$325	14.6	
9	15,575	School Teacher	41	3	Yes	Used	35,000	1,350	33,650	321	24.7	
10	31,150	Electrician	32	1	No	Used	42,500	3,250	39,250	378	14.6	
11	19,420	Truck Driver	24	0	Yes	Used	37,500	2,250	35,250	340	21.0	
12	25,250	Engineer	32	1	Yes	Used	44,000	3,550	40,450	384	18.3	
13	16,300	Truck Driver	38	2	Yes	Used	37,100	2,150	34,950	327	24.1	
14	12,000	Assoc. Mgr.	25	1	Yes	Used	39,500	2,250	37,250	345	34.5	
15	14,400	Service Writer	33	2	Yes	Used	41,950	2,650	39,300	361	30.0	
16	11,600	Factory	29	2	Yes	Used	32,000	1,000	31,000	296	30.6	
17	7,680	Machinist	26	0	Yes	Used	23,000	700	22,300	229	35.8	
Average	$18,088		32.6	1.2			$36,805	$2,060	$34,745	$331	24.8%	

Notes

1 Loan applications in process, March 23, 1977

2 Monthly payment for principal, interest, taxes and insurance

Glendale Federal Savings
Corporate Planning Dept.
March 1977

TABLE 2

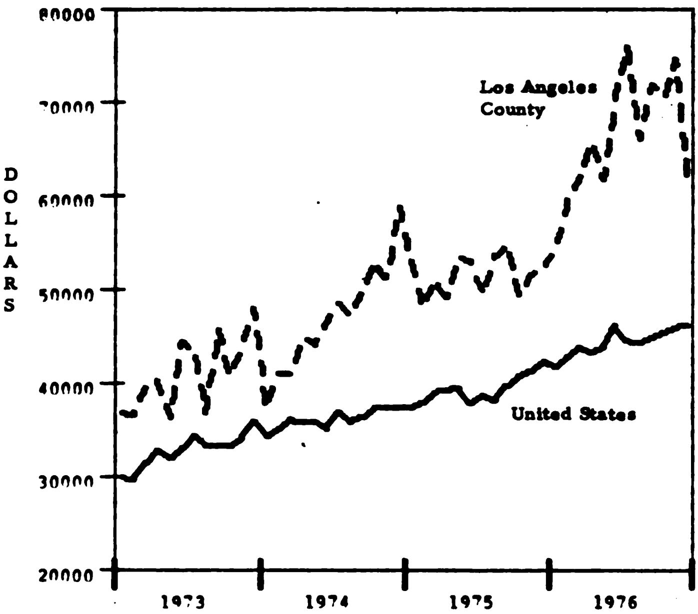
PROFILE OF RESPONDENTS
Focus Groups on Mortgage Instruments
Glendale Federal Savings
December, 1976

		Number	Percent
1.	Current age of respondent		
	Less than 35	12	55%
	35 - 45	8	36
	More than 45	2	7
	Total	22	100%
2.	Profession of head of household		
	Management	5	23%
	Data Processing	5	23
	Engineer	2	9
	Attorney	2	9
	Accountant	1	5
	Real Estate	1	5
	Teacher	3	11
	Employment Counselor	1	5
	Mechanic	1	5
	Truck Driver	1	5
	Total	22	100%
3.	Number of homes owned as principal residence (including present home)		
	One	10	45%
	Two	8	36
	Three	3	14
	Four or more	1	5
	Total	22	100%
4.	Years lived in present home		
	Less than one	12	55%
	Between one and two	9	41
	Between three and five	-	-
	More than five	1	4
	Total	22	100%
5.	Loan amount on present home		
	Less than $25,000	1	5%
	$25,000 - $34,999	9	41
	$35,000 - $44,999	5	23
	$45,000 - $54,999	4	18
	$55,000 or more	3	13
	Total	22	100%
6.	Current mortgage interest rate		
	8%	1	5%
	8-1/2%	1	5
	8-3/4%	6	27
	9%	-	-
	9-1/4%	9	41
	9-1/2%	4	17
	No response	1	5
	Total	22	100%

Glendale Federal Savings
Corporate Planning Dept.
March 1977

CHART 3

New Single-Family Home Sales Prices



Source: Federal Home Loan Bank Board
U. S. Departments of Commerce and Housing and Urban Development

Glendale Federal Savings
Corporate Planning Department
April 1977

Senator [illegible]: If you will do that I will go on.

Senator [illegible]: Fine. [illegible] we [illegible] to [illegible] a little problem.

STATEMENT OF [illegible], PRESIDENT AND [illegible] OF THE [illegible] ASSOCIATION, [illegible], REPRESENTING THE UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS

Mr. [illegible]: I will try to read my statement.

(Complete statement follows:)

STATEMENT BY JOHN RAYMOND ON BEHALF OF THE

U. S. LEAGUE OF SAVINGS ASSOCIATIONS

TO THE

SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

MARCH 31, 1977

Mr. Chairman: My name is John U. Raymond. I am Chairman of the Board of Home Federal Savings and Loan Association of Washington, D. C. and appear today in my capacity as an Executive Committee Member of the United States League of Savings Associations*.

The U. S. League appreciates this opportunity to testify at your hearings on S. 664, Senator Brooke's "Young Families Housing Act of 1977" and Chairman Proxmire's S. 1078 establishing the FHA Section 245 program on a permanent basis. These bills address some basic barriers to home ownership today: the availability of mortgage money throughout the business cycle; acquiring a downpayment; and, greater flexibility in meeting monthly loan payments.

Mr. Chairman, members of the Committee, the savings and loan business is deeply concerned over the ability of the American family -- especially the

*The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,400 savings and loan associations, representing over 98% of the assets of the savings and loan business. League membership includes all types of associations -- Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: John Hardin, President, Rock Hill, South Carolina; Stuart Davis, Vice President, Beverly Hills, California; Lloyd Bowles, Legislative Chairman, Dallas, Texas; Norman Strunk Executive Vice President, Chicago, Illinois; Arthur Edgeworth, Director-Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 E. Wacker Drive, Chicago, Illinois 60601; and the Washington Office is located at 1709 New York Avenue, N. W., Washington, D.C. 20006; Telephone: (202) 785-9150.

young family starting out in life -- to save towards a down payment and sustain the monthly payments needed to acquire a home. Recent studies by the Congressional Budget Office and the Joint Center for Urban Studies of the Massachusetts Institute of Technology suggest that affordability is a growing problem for families in almost every economic and social strata.

We think both the Brooke and the Proxmire bills deserve the most serious consideration, since they seek to address some of the basic problems that families face in acquiring a home. These innovative proposals would cut mortgage payments for modest income home purchasers, provide lenders with a mechanism for adjusting to inflation and minimize government expenditures.

* * *

We are particularly impressed with Section 3 of Senator Brooke's S. 664 -- the tax incentive plan permitting accumulation of $10,000 toward downpayment on a home. This proposal for an "individual housing account" (IHA) would help prospective home buyers systematically save for their home purchase and provide great stimulus to the capital formation needed by the housing sector of our economy. As we have discussed before other Committees of the Congress, saving for future needs makes a major contribution to the fight against inflation. Our country's heavy tax burden acts as a disincentive to savings. In order to acquire a downpayment, households must first have enough after-tax dollars to put aside in a savings account and then must suffer the consequences of paying taxes on the interest accrued on these accounts. The IHA successfully eliminates both of those disincentives.

This new version of the IHA improves on S. 3692 of the last Congress by reducing potential revenue loss to the Treasury. The provision adjusting the basis at time of sale by the amount of the downpayment achieved through use of an IHA will permit the Government to recapture eventually some of the tax-sheltered savings. We understand that the technical language targetting this tax incentive to first-time home buyers may be reviewed further by the Treasury and appropriate tax-writing Committees and we would be happy to provide additional suggestions as this legislation proceeds in the 95th Congress.

In short, Mr. Chairman, Senator Brooke's Individual Housing Account is one of the most powerful incentives I can imagine for thrift and home ownership.

* * *

We also endorse the Graduated Payment Mortgage portion of S. 664 and S. 1078, and agree with Senator Brooke's observation that the FHA Section 245 program may be easier to understand than his "Equity Adjusted Mortgage" proposal last summer.

The pronounced escalation in home prices in recent years is due to many factors -- water and sewer moratoria, environmental concerns, labor rates, land costs, building code restrictions, rising property taxes, stop and go economic patterns, and so forth. Lending institutions, scarred by a dozen years experience, have built future inflationary expectations into their rates charged new borrowers. As we have testified on numerous occasions

all these factors create barriers for home ownership by young families purchasing their first house.

One of the greatest rigidities in the present system is the almost universal reliance on the fixed-rate, long-term home mortgage loan. Just as the Federal Housing Administration popularized the amortized loan forty years ago, we believe that the FHA's Section 245 program can win public acceptance for Graduated Payment Mortgages today.

There is, unfortunately, one limiting factor that may seriously reduce the practicality of offering these GPM mortgages in the market place. A number of state usury laws include a provision which makes it illegal to offer loans that result in the payment of "interest on interest." We commend the authors of S. 664 and S. 1078 for recognizing this potential problem and seeking to correct it in the language of their bills. We have long opposed usury limits as counter-productive, inefficient, and contrary to the needs of the home-buying public, and would hope that consumer acceptance of the Graduated Payment Mortgage would encourage state legislators to remove these artificial restrictions on a broader scale.

As a technical matter, we prefer the language of S. 1078: "the principal obligation (including any interest which may be deferred and added to principal) of a mortgage insured pursuant to this section . . .", to the comparable language in Section 2 of S. 664, since the S. 1078 phrasing deals more clearly with the total outstanding indebtedness.

Of perhaps greatest importance, expansion of the Section 245 program encourages greater experimentation, both contractually and through legislation and regulation, with other forms of alternative mortgage instruments. Flexibility in mortgage loans would provide new options which may appeal to a broader segment of the population which is currently unable to enter the housing market because of the monthly payment rigidity found in existing long-term, fixed-rate mortgage contracts.

When the U. S. League appeared before your Housing Subcommittee last August we spoke at length of the growing acceptance of the most prominent of these alternative mortgage forms -- the variable rate mortgage now in use at state-chartered savings and loan associations (and some state and national banks) in California. We would reaffirm that testimony today, and urge prompt consideration by your Committee of Senate Concurrent Resolution 9 sponsored by Senators Cranston and Tower -- which provides a Congressional signal for the Federal Home Loan Bank Board to proceed with variable rate authority, at least on an experimental basis, at Federally-chartered S&Ls.

Other mortgage loan innovations are being examined by our business and the FHLBB including:

*- Interest-only provisions for the first five years, as now permitted by Section 545.6 of the rules for Federal associations; these loans, which are being tested in a number of locations, lower the initial monthly payments and avoid the "negative amortization" and initial increase in principal indebtedness implicit in the FHA 245 plan.

- The step-rate plan being used at a mutual savings bank in the State of Washington, which, we understand is growing in popularity -- particularly with families at the "margin" of mortgage eligibility.

- The "Brock-Ashley" proposal reviewed as S. 3193 by your Housing Subcommittee last summer, providing a variable rate for lenders, a fixed monthly payment for consumers, with a recapture arrangement.

- Separate loan arrangements for the land and the dwelling.

- Contractual provisions enabling a borrower to obtain an additional line-of-credit supported by his payment performance, and "skip payment" clauses to permit consumers to miss their monthly obligation when suddenly unemployed or disabled.

- "Reverse mortgages" which would permit S&Ls and other financial institutions to offer their established customers annuity-like payments enabling them to "unlock" the savings that the built-up equity in their home represents; this would be particularly helpful to older couples on limited retirement incomes faced with rising utility bills and other living costs.

As you know, these and other changes are under detailed examination as part of the FHLBB's ongoing Alternative Mortgage Instruments Research Study. We are confident that the Board's effort and those in the business itself will expand the home ownership opportunities for the American public.

* * *

In conclusion, I wish again to commend Chairman Proxmire and Senator Brooke for their important contributions to the critical area of home finance.

The U. S. League supports S. 664 and S. 1078, and urges their prompt approval by your Committee and the Congress.

I appreciate this opportunity to present the views of the U. S. League, and I would be most pleased to respond to your questions.

Senator BROOKE. Thank you, Mr. Raymond.

STATEMENT OF ROBERT W. IRVING, SENIOR VICE PRESIDENT, EQUITABLE TRUST CO., BALTIMORE, MD., REPRESENTING THE AMERICAN BANKERS ASSOCIATION

Mr. IRVING. Thank you, Senator Brooke. I, too, will try and cut down my statement in the interest of time.

[Complete statement follows:]

STATEMENT OF
ROBERT W. IRVING
FOR THE
AMERICAN BANKERS ASSOCIATION
BEFORE THE
HOUSING AND URBAN AFFAIRS SUBCOMMITEE
OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
ON S 664 and S 1078

MARCH 31, 1977

Mr. Chairman, my name is Robert Irving, and I am Senior Vice President of The Equitable Trust Company, Baltimore, Maryland. I also serve as the Chairman of the Government Relations subcommittee of the Housing and Real Estate Finance Division of the American Bankers Association.

Mr. Chairman, as you will recall, ABA testified before this subcommittee last August concerning measures introduced by Senator Brooke and former Senator Brock of Tennessee which approached the subject of alternative mortgage instruments with great imagination. Senator Brooke's bill offered a plan to make available the "equity-adjusted mortgage" -- a concept which the ABA found to have much potential in the mortgage marketplace. Although this plan suggested an instrument which might have been found to be relatively complex for both lenders and borrowers, the concept offered an idea which, given the proper circumstances of increasing incomes and appreciating property values, would have served many mortgage customers quite well. Needless to say, we are delighted to come before this Subcommittee again in support of an even more acceptable plan to serve the homebuying public.

Prior to covering specific points outlined in S 664 and S 1078, let me add my support and that of the ABA to your recognition of the fact that the main obstacle facing the young homebuyers of this nation today is the "affordability problem". Inflation, as many witnesses point

out, is housing's number one problem. The value received by the homeowner compared to the cost of ownership is slowly being reduced to the point that many families do not feel comfortable with their monthly housing payments. Not only have sale prices of homes escalated, but taxes, insurance, maintenance and utility costs have created in the minds of the first-time home purchaser a picture of potentially significant financial difficulty even after the purchase price is achieved. This winter and resulting energy costs at least temporarily depressed both the prospective purchaser and the housing market itself.

As an aside, you may be interested to know the American Bankers Association looks forward to President Carter's energy message to be delivered to the Congress and the Nation on April 20. In advance of that message, we at ABA are calling together a Banking Task Force on Energy -- with the impact of energy shortages and energy-related costs on housing as a prime concern.

As I have stated, ABA is anxious to support new ideas which will bring homeownership to more Americans--young and old. The graduated payment mortgage (GPM) is clearly a concept which may cause that desire to become reality. Senator Brooke's plan as expressed in S 664 is more understandable to the bank customer. According to the HUD outline for this new instrument, the GPM offers a reduced mortgage payment in the early years of property ownership. It offers the younger customer the opportunity to enter a home earlier than is now the case and thus, begin to build equity for the future.

There are, as we must all recognize, some drawbacks to the plan:

- Equity build-up may be delayed.
- Resale may be difficult during the early years.
- Increasing income is assumed.
- Property value appreciation is assumed.

- Early payment reduction is slight.

These drawbacks, however, should not force the abandonment of this and other progressive thoughts concerning alternative mortgage plans. In fact, the ABA would endorse this bill's provision giving FHA/HUD the authority for some permanence in its experimental graduated mortgage payment program to begin this year. With careful review, this program should give all concerned the opportunity to refine the GPM and make it a common --and valuable-- alternative mortgage instrument.

As this Subcommittee is aware, under the GPM program, initial monthly payments would be smaller than they would under a standard FHA mortgage arrangement. As the payment amount grows over the years, the monthly installment would eventually be somewhat higher than under a standard loan. Therefore, in effect, both principal and some interest payments are initially deferred and subject to interest charges. Laws in at least 32 states prohibit charging interest on interest and several title insurance companies are now writing exceptions to title coverage for that portion of the GPM which represents interest on deferred interest. Considering the fact that FHA requires a clear title to insure its loans, insurance of such loans is effectively barred in these states.

We are delighted to note that the provisions of S 664 and S 1078, as well as language contained in H.R. 4703, a bill introduced by Congressman Thomas L. Ashley of Ohio, would preempt state law in order to allow such GPM's to be insured.

It may be appropriate to point out that initial indebtedness which may amount to 97% of the appraised property value concerns most mortgage lenders. These proposed amendments to the National Housing Act can potentially place a large burden on the lender and homebuyer. The approach to this aspect in S. 1078 is much preferred as it suggests a loan not to exceed 97% of total

outstanding indebtedness. We must point out, however, that S. 664 would require a 10% payment on account which would ease the burden considerably. Should Individual Housing Accounts as proposed by Senator Brooke in S.664 become available, this 10% could become a more acheivable objective for the home purchaser.

Again, these provisions as well as others have the full attention of ABA with the hope that the few aspects of the measure which detract from its effectiveness can be addressed, making this plan workable.

The second and most interesting aspect of Senator Brooke's proposal is the Individual Housing Account (IHA). This account would, as Senator Brooke has pointed out, operate on a similar principle to the Individual Retirement Account. A prospective homebuyer would be allowed to place up to $2500.00 a year with a ceiling of $10,000.00 into the IHA and up to 10 years later use these funds as a downpayment on a first home purchase. The amount accumulated in an IHA for this purpose would be carried as a capital gain until the ultimate property was disposed of.

As you recall, the American Bankers Association supported this idea when it was last introduced by Senator Brooke. That support continues. We point only to the total impact on U.S. tax revenues due to the tax deductability of the IHA. However, we would have to conclude that at this point that impact's extent is unknown. Fiscal considerations which must be faced whenever there is a loss to tax revenue are always a concern.

Individuals will be allowed -- as they should -- to open IHAs at several types of institutions: thrift institutions as well as commercial banks. But all IHAs will not be the same, because the commercial banks currently

cannot pay as high a rate of interest as the thrift institutions. The perceived rationale for the existance of an interest rate differential is to attract savers' funds into thrift institutions which supposedly carry a mandate to reinvest these funds into the housing marketplace. In any case, a differential for IHA's is not necessary because the funds collected in IHA's are already earmarked for housing.

We believe that most financial institutions will want to offer IHAs to their customers--and that competition will be intense. But commercial banks will be at a severe competitive disadvantage.

Banks have faced the same problem with Individual Retirement Accounts. Banks have been severely handicapped in competing with the thrift institutions for IRA business, and it is evident that --without relief from the interest rate differential--they would find themselves in the same situation with IHAs.

To document this fact, perhaps this Subcommittee would be interested in the conclusions of an IRA Task Force of the ABA which were forwarded to Chairman Burns at the Federal Reserve Board on March 3, 1977. These conclusions were (in part):

"The interest rate differential problem has become exceedingly acute. Federal Reserve survey figures show that, based on nationwide averages, a savings and loan will have four times the number of IRA dollars that reside in commercial banks. Mutual savings banks have seventeen IRA dollars to every one that a bank records. Estimates based on that survey indicate that the savings and loan industry has 120,000 more IRA accounts than the banking idustry; yet there are 5,700 less associations offering these accounts. About 285 mutual savings banks control 52% of the total number of IRAs that

banks have been able to attract. As yet another year-end "selling season" goes by and these dollars become compounded, the banking industry continues to lose both earnings and the ability to provide maximum service to its customers. Numberous reports from bankers, as well as first hand experience by the task force members indicate that many customers shop at banks, but "buy" IRAs at thrifts in order to earn the quarter percent differential.

"The Task Force members are well aware that Congress has been attempting to balance conflicting policy goals by mandating an interest rate differential, but believe that the legislative history of ERISA indicates that Congress' goal in the Act was the creation of a retirement savings instrument that would maximize the savings of all Americans. Differential interest losses to bank customers, we are convinced, are directly contrary to the intent of ERISA. The extent to which the differential contradicts Congressional intent may be dramatized by consideration of differential interest losses on a one thousand dollar per year contributory IRA on which a bank may pay only 7 1/2% while an S&L is authorized to pay 7 3/4%. Losses on a single year's deposit over a period of twenty years of quarterly compounding will exceed $220. During that same twenty years, total differential losses will exceed $1,300 on all deposits.

"Not only does the differential penalize current bank IRA customers, but it also denies all potential retirement account holders the ability to choose among sponsors on the basis of quality of service and convenience. Thus, returns become the overriding determinant of sponsor for most potential IRA customers. Most affected by this limitation on freedom of choice are those employees residing in areas not served by thrift institutions. For them, the inconvenience necessarily accompanying the decision to seek the higher returns which they deserve, constitutes the equivalent of a discriminatory tax on their time and resources.

"The differential also has a severe impact on bank personnel. The demoral-

izing effect of seeing old and valued bank customers opening IRA accounts at competing thrift institutions after being convinced of the IRA's value by bank employees is beyond estimation. Moreover, the effect of compound interest on long-term IRAs, and the fiduciary nature of such accounts, has induced in many bankers the feeling that they may be breaching a depositor's trust by encouraging him to open a bank IRA. This feeling is perhaps best summarized by a quote from a recent letter which ABA received. A banker wrote, 'As long as banks are in their current position, would a prudent person - armed with reasonable information - choose a national bank's IRA plan?'

"Thus, it is our belief that the elimination of the differential on commercial bank individual retirement accounts is not only supported in law by ERISA, but is a vital precondition for maximizing benefits to all individual retirement savers."

Considering these recommendations, the American Bankers Association urges this Subcommitee to include in S 664 a provision that the interest rate differential not apply to IHA accounts. Pegging the interest rate at the same level for commercial banks and thrift institutions will ensure equal competition for such accounts--and allow savers the broadest possible choice. We are not urging any special privilege for commercial banks--merely equity!

We believe it may be wise to consider allowing the rate of interest to be flexible within the limits of Regulation Q. Fluctuating rates, tied to a visible money market indicator, should, I believe, be allowed for IHAs. Notice of changes in fixed rates, either increases or decreases, should be sent to the customer at least ten days prior to the effective date of the change.

One final recommendation--that the reports required of lenders under the act not be burdensome. All financial institutions are currently innundated

by the Federal paperwork burden. And while we understand the need for reporting under the act, we urge this Subcommittee to carefully review any regulation emerging to insure clear and concise reporting requirements.

In summary, the American Bankers Association endorses the principles and concepts embodied in S 664 and S 1078. The minor defects in the legislation (already noted) can, we believe, be overcome so that graduated payment mortgages and Individual Housing Accounts can become valuable and widely-accepted alternative means of providing housing to our nation's citizens.

With respect to Individual Housing Accounts, however, we believe that S 664 should specifically remove the interest rate differential between what banks and savings and loan associations can pay on such deposits in order to ensure fairness to the customers of all financial institutions in saving their housing dollars.

We thank you for this opprotunity to appear here this morning to discuss these important issues. I would be happy to try to answer your questions as they occur.

The CHAIRMAN. Thank you very much. I want to thank all of you gentlemen for your testimony. I guess I completely missed the testimony of Mr. Raymond. I understand it was terse and to the point and I appreciate it.

Now, Dr. Klaman, in your testimony you seem to indicate that while you approve of the legislation and you thought it would open choices and that that would be helpful, I interpreted you to feel that this would not solve the problem overall. This was not a major solution in the sense that we could expect that we could rely on this particular kind of legislation to do the job. Is that right?

Dr. KLAMAN. I think that's a fair statement, Senator. A great deal more needs to be done and its use to the public would be quite limited.

The CHAIRMAN. And that was pretty much the concensus that I got from all you gentlemen. You approve this. You think it's useful. You think it's a good initiative, but it is limited and it's nothing that will provide half a million or a million housing starts a year that we didn't have before or even 200,000 or 300,000. Is that correct?

Dr. KLAMAN. Definitely so.

The CHAIRMAN. Now on page 3 (see page 64), Dr. Klaman, you suggest that lenders may have a cash flow problem with this instrument, the GPM. Would you expect there to be a significant impact on their credit policies? Will credit be more restricted to home buyers? What will the effect of higher downpayments be on buyer demand?

Dr. KLAMAN. It would be—you mean the 10 percent downpayment?

The CHAIRMAN. Yes, sir.

Dr. KLAMAN. I suppose that it would be a limitation on younger families if that were required, obviously depending on the price of the house. But we find by and large that we have very few loans that are less than that—except perhaps the GI loan. The 10 percent downpayment is apparently not beyond the ability of the market that is served by most savings banks on an average-priced house. We have a lot of housing in the Northeast that are below this medium of $40,000. My son lives in a lovely 3-bedroom 2½-bath house that he bought for $30,000 in Massachusetts.

The CHAIRMAN. Mr. Buckley wants to know where. He wants to buy it.

Dr. KLAMAN. I'll tell you; we have two others just like it we rent.

The CHAIRMAN. When? 1930?

Dr. KLAMAN. About 8 months ago in Amherst, Mass. It's a depressed area. The university is reducing its staff.

But seriously, sure, these are problems, but obviously when you have this kind of a loan where the balance increases, it's hard to combine no downpayment and a rising balance. I don't think that they are going to make more severe credit restrictions. Our concern is—Mr. Nevins and I didn't come up with these ideas. This was subjected to a very rigorous review by a task force of on-the-line savings bank mortgage lenders. They came up with these concerns.

They said they would make these loans, sure, but it depends on the demands for credit and the alternative uses in mortgage markets, and I think it's the kind of problem that concerns them. That's why

they said: Let's offer this buyer alternative choices. They may go for the step rate plan which has an amazing success in the State of Washington, and I'm going to leave a little brochure with the committee so you can see how it works. But that's geared to the younger family, with a maximum $40,000 house price. They will not entertain housing of a higher value for this kind of loan.

The CHAIRMAN. Let me ask Mr. Smith. In fairness to Senator Brooke, this is a different kind of instrument. We haven't had the tax feature, for instance, in the law before now so that makes the downpayment certainly a lot more available.

Nevertheless, the Federal Home Loan Bank Board, not the FHA, several years ago permitted savings and loans to offer what it calls flexible payment mortgages which essentially are GPM's. It's my understanding that this authority has been almost totally ignored by Federal savings and loan associations. Is that the case, and if so, why would S&L's be more interested in the FHA GPM's?

Mr. SMITH. Senator, I'd have to state unequivocably that it has been ignored by the savings and loan industry for the simple reason that the benefits to the borrower are so miniscule that it's hardly worth the effort. For example, with a $35,000 flexible-payment mortgage, the monthly mortgage payment is $15 less than a conventional level-payment loan, which is not enough incentive to the borrower to make the difference.

The CHAIRMAN. How would this provide the additional incentive?

Mr. SMITH. On this same loan, one of the versions of the FHA loan would lower the payments $75 a month, which is enough to make a critical difference to the borrower. We do issue flexible rate loans at Glendale Federal and I think I can count them on both hands and feet. We have had the program over a year and we have had less than 20 people who have taken them where we have tried to sell them, and in effect, the customer has said, "Don't bother me with that. It's not worth it."

As I said, we have started trying to issue graduated payment mortgages. The big problem has been that we can't advertise them. We've only got 50 of them and we originate 2,500 to 3,000 loans a month. We cannot advertise that the GPM is available or we'd use up our 50 so fast that we'd have the public mad at us.

The CHAIRMAN. Mr. Irving, it seems to me a lender would have to be fairly conservative about giving out a GPM, both regarding the income potential of the borrower which is a little different than just estimating what he's got now, and assuming it will be stable, assume it's going up, and the resale potential of the property. Would you agree with that?

Mr. IRVING. Yes. I think you have to qualify it in one respect. Dr. Klaman referred to it. In this particular case, we are dealing with an FHA insured loan, so there is that protection from the lender's viewpoint.

Dr. Rosen answered a similar question by saying, yes, I think there would be a tendency on the part of lenders to be more conservative. I think that would be especially true with conventional loans, but I would have to agree that even with the FHA none of us want to get involved in foreclosures and we probably would be a little con-

servative, concerned about the potential for income growth and the potential for appreciation.

The CHAIRMAN. Mr. Raymond, would you contemplate offering the GPM at a higher interest rate than the standard mortgage in order to compensate you for your increased risk and lower early cash flow?

Mr. RAYMOND. Senator Proxmire, I don't believe that we would necessarily feel that a higher interest rate would be appropriate on this type of loan. Our interest rates are more often dictated by our cost of money and by other competitive factors which we have no control over.

The CHAIRMAN. Of course. I'm just saying would there be any differential here? I'm sure your overall industry would have to vary with that.

Mr. IRVING. I would not anticipate that this would necessarily have to carry a higher interest rate.

The CHAIRMAN. I have a lot more questions, but in view of the hour I think I will just have to restrain myself and ask them for the record. When you gentlemen correct your remarks, I would appreciate it if you could answer these.

Senator BROOKE. Dr. Klaman, in your testimony you spoke about the need for higher origination and service fees for graduated payment mortgages. Now is your request for higher fees simply a reflection of a general belief that FHA allowed fees are too low? I personally feel it would be quite easy to prepare a single document and chart which would clearly set forth the payments for each month for each plan and thus eliminate most, if not all, of the confusion. Many institutions are doing that now with considerable success. I would like to know the basis for your statement.

Dr. KLAMAN. It's entirely possible, Senator Brooke, if these loans rise to great popularity competition in the marketplace probably would prevent taking advantage of the maximum fee permitted. However, I'm looking at table 2 that Dave Smith graciously provided in his testimony and if you're sitting down with a borrower and there are five choices under this graduated payment program. There's a 2½, 5 percent and 7½ percent possibility. I think just in terms of the time, and I think it was pointed out here in your absence, Senator Brooke, that you have to train people to explain this and it's going to take more to explain this than a simple level loan. This is a loan, simple monthly rate, and period. When you're looking at all these plans, and time is money and costs, it just seems to me fair to recognize that it's a different kind of instrument than the other FHA loans and therefore deserves to be treated a little differently.

If that doesn't provide to be the case, hopefully those origination fees won't be exacted. I think we need some incentive here. I'm looking for the incentive for the lender to put the funds out. Our people are quite willing to meet the market and make the loans. The task force that we organized to look at this proposal came up with these suggestions and I would be unhappy if this legislation passed and there was no activity—a big party and nobody came. Why wouldn't they participate in this program? What are the advantages to the

lenders in the private enterprise economy of free financial markets that would want them to really come into it? What is the incentive to the lender to participate in this program? Is he worried he can't get his funds out because there's isn't enough housing demand? Is he just choking up to here with deposits that can't be channeled effectively through the marketplace? I don't think that's the case. If Professor Rosen's projections are correct—and let's give him the benefit of the doubt for the moment—we are going to be swamped with housing demands. Even if 50 or 60 percent of American families can't afford housing, if only 40 percent can, that's a tremendous amount of housing. That's more housing than we have ever built in this country. So we have to have some way, if we believe in this system, in our private market system, to attract the lender to this instrument. That's why I say maximize the choice.

Senator BROOKE. And you think that higher origination fees would be attractive to lenders.

Dr. KLAMAN. I think that at least shows him that we are aware of his problems, that there are costs, real costs when he sits down. I want to tell you—and I'm sure my savings and loans and commercial banks colleagues would join me—our major concern is the bottom line. I found in the 19 years I have been in the savings bank industry that the focus has shifted dramatically from growth as the major measure of performance to earnings, and surplus. We are under constant pressure from our supervisory authorities telling us that our surplus ratios are too low, our earnings are too low, and we've formed task forces to estimate costs of doing business. The NOW account, which is a fantastic instrument which you played such a large role in legislating, we are looking at that because you can't pay 5 percent and give it away free and make money, not even in volume. It just doesn't add up. So this bears on that.

Now you've got another instrument and we're going to look at it and say, "They want us to do this and they're not giving us one bit of incentive to do it."

Senator BROOKE. You don't have to pay 5 percent interest rates.

Dr. KLAMAN. I know. That's the marketplace. That's what I mean. Maybe it will go down. Maybe costs will go up.

Senator BROOKE. Mr. Smith, you're already doing this. Do you think you need incentives? Do you think higher origination costs are necessary?

Mr. SMITH. Senator, we have only seven applicants right now, so it's kind of hard to extrapolate seven individuals. Our experience with them, though, has been that it does take longer to explain it. It is more complicated. We do have to process it by hand right now because we cannot computerize for 50 loans. And I would have to concur with most of Mr. Klaman's comments that some kind of additional fee may be the key incentive that lenders need, at least until they find out how much more difficult these are going to be. We will operate very differently with 50 loans than if we had an unlimited number of them. We will conduct more extensive training programs for our lending officers. I trained the officers that are doing this and it's been a bootstrap operation, but the problem with the FHA loan with the interest rates and the very low fees does not give the lenders

much incentive to get into the program. We do believe, however, over time and through the use of charts and graphs like this we can explain the instrument to the customer in an understandable way without costing us a fortune, but it's obviously more complicated than the level payment loan. Someone, somewhere is going to have to bear those costs.

Senator BROOKE. Now, Dr. Klaman testified in response to Senator Proxmire's question, that this program would not have a very great impact on the level of housing starts. Do you agree?

Mr. SMITH. Yes, Senator, but it's not a function of a graduated payment mortgage but the function of the FHA marketplace. FHA lending nationwide accounts for less than 10 percent of all mortgage lending activity in any one lending year. In southern California, FHA lending is virtually extinct because of the $45,000 loan limit and so it's an FHA problem, not a graduated payment mortgage problem. It would be far more constructive to offer GPM's on conventional, uninsured loans. Therefore, the National Savings and Loan League urges this committee and the Congress to enact Senate Concurrent Resolution 9, so that the Federal Home Loan Bank Board can authorize the creation of several new mortgage designs for the conventional market.

Senator BROOKE. If they were offered in the conventional mortgage market, what would be the effect?

Mr. SMITH. If they were offered, my frank forecast is that the consumers would choose these overwhelmingly over conventional loan payments and would drive the conventional mortgage into extinction. It would take a number of years to do this, but I personally believe that would be the outcome.

Senator BROOKE. Mr. Irving, in your statement you say that the ABA endorses the principles and concept embodied in the bill before us but you continue by saying that the minor defects in the legislation can be overcome.

Now I'm not sure about the defects you refer to. You list a number of drawbacks of the GPM's, but I don't clearly see the resolution of those problems. For example, you say Chairman Proxmire's approach to this aspect in S. 1078 is much preferred as it suggests a loan not to exceed 97 percent of total outstanding indebtedness:

> We must point out, however, that this concept amounts to a borrower's equity position of no more than 3%—a position hardly sufficient to provide a lender and FHA with assurance against default. This provision seems particularly troublesome if individual housing accounts as proposed by Senator Brooke in S. 664 become available.

Now how should this be corrected?

Mr. IRVING. Well, there are several questions there I think and one I will take the opportunity to say that for the record I changed the word "defects" to "concerns" and agree these are not defects.

Senator BROOKE. They are minor concerns?

Mr. IRVING. They are minor concerns. Most of them have been expressed.

Senator BROOKE. I accept the amendment. Go ahead.

Mr. IRVING. The 3 percent, what we're really saying is that this is very marginal equity. It's not much in terms of dollars or equity to

protect the buyer. I guess I'm influenced by an experience in the early days of the 1960's where somebody with 3 percent equity and a nonappreciating housing market who had to sell their house had to pay 6 or 7 percent to sell the house to pay back 3 percent equity.

We are supporting the bill that requires the 10-percent downpayment because with this increasing principal amount we think this provides some cushion both for the borrower and the lender and I think for the FHA.

Senator BROOKE. Do the rest of you concur with that?

Mr. SMITH. Senator, I would disagree on maybe a technical point. I think the downpayment requirement ought to be determined by the borrower and the lender rather than legislated in concrete. It may be that in some areas a 10-percent downpayment would be the absolute minimum and in others it may be a function of the geographical area or the borrower, 3 or 5 percent down.

The CHAIRMAN. How realistic is the 10 percent, in your opinion?

Mr. SMITH. Well, I would guess if it wasn't legislated, the average downpayment might be 8 to 10.

The CHAIRMAN. Senator Lugar.

Senator LUGAR. No questions.

The CHAIRMAN. That's correct, and I will submit mine for the record, too. Gentlemen, thank you very much. You are certainly an outstanding and expert panel.

Our final panel is Mr. Robert Arquilla, president, National Association of Home Builders, and Daniel C. Hanrahan, chairman, Legislative Committee, National Association of Realtors.

Under the circumstances, we would appreciate it if you would abbreviate your statements. The entire statements will be printed in the record in full.

Mr. Arquilla, go right ahead.

STATEMENT OF ROBERT ARQUILLA, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, ACCOMPANIED BY CARL A. S. COAN, JR., LEGISLATIVE COUNSEL; AND J. DENIS O'TOOLE, DEPUTY LEGISLATIVE COUNSEL

Mr. ARQUILLA. Thank you, Mr. Chairman.

[Complete statement follows:]

NATIONAL ASSOCIATION OF HOME BUILDERS

National Housing Center

15TH AND M STREETS, N.W., WASHINGTON, D.C. 20005

TELEX 89-2600 TELEPHONE (202) 452-0200

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

on

S. 664, YOUNG FAMILIES HOUSING ACT

and

S. 1078, AMENDMENT OF SECTION 245 OF THE NATIONAL HOUSING ACT

MARCH 31, 1977

Mr. Chairman and Members of the Committee:

My name is Robert Arquilla, and I am a home builder from Chicago, Illinois. I am testifying today on behalf of the more than 82,000 members of the National Association of Home Builders, the trade association of the nations home building industry, of which I am President. Accompanying me today is Carl A.S. Coan, Jr., NAHB's Legislative Counsel, and J. Denis O'Toole, Deputy Legislative Counsel.

We appreciate the opportunity to discuss with you some suggested new approaches that can be pursued by the Federal government in its continuing effort to achieve the national goal of "a decent home and a suitable living environment for every American family." The concept of S. 664 and S. 1078 for expanded use of alternative mortgage instruments, and the concept of S. 664 for the use of individual housing accounts are certainly two ideas worth exploring. Our industry in recent years has been encountering a whole range of moderate and middle income buyers who have neither the current income nor the downpayment needed to qualify for a standard, level-payment mortgage loan. And because the home building industry is so concerned about the increasing percentage of families priced out of the housing market, we commend to you as another approach for consideration, NAHB's Common Sense Housing Subsidy Program. This we have designed to specifically meet the needs of families priced out of the market as a result of high mortgage interest rates.

To some, it may seem paradoxical that in the same month that the seasonally adjusted annual rate for single family housing starts neared a record level, a significant new study of the nation's housing situation prepared by the Joint Center for Urban Studies of M.I.T.-Harvard makes some dire predictions about the ability of an average-income

American family to afford to purchase a new home. Yet, the fact is that a majority of the purchasers of today's new homes are affluent families with incomes substantially above median income levels, and so we indeed face the unprecedented prospect of seeing many average, middle-income families denied the opportunity for home ownership.

The explanation for why the American family is in danger of being priced out of the new home market, simply stated is that the costs of home ownership have outpaced increases in available income. Over the past six-year period in which double digit inflation was severe, the median price of a new house rose from $23,400 in 1970 to $44,200 in 1976. At the same time, other home ownership costs, according to Bureau of Census data, such as real estate taxes, fire insurance, home maintenance and repairs, and heating and utility costs increased at an average rate of between 10 and 15 percent annually. And to all these costs, must be added the increased cost of mortgage credit, which is the ultimate factor squeezing families out of the housing market.

Unfortunately, the problem of housing affordability weighs heaviest on younger couples, themselves the product of the post-war baby boom, who are now in the process of forming their own families. Because of high mortgage interest rates, many of these families are priced out of the housing market, or, at the very least, find they must pay a significantly larger percentage of their family income for housing costs.

We recognize that the level payment mortgage ignores the probability that the typical young family's income will rise over the family's working years, and that a graduated payment type of mortgage would provide lenders with much greater flexibility in qualifying the home buyer for a mortgage loan.

NAHB, except in regard to variable rate mortgages which it opposes, has not adopted any policy position with respect to graduated payment mortgages or other forms of alternative mortgage instruments. Our staff is monitoring HUD's experimental finance program under Section 245, which provides five alternative graduated mortgage payment plans. We, also, are watching with interest the Federal Home Loan Bank Board's Alternative Mortgage Instrument Research Study (AMIRS). Once the data from these undertakings is available for analysis, we would hope to have specific guidance from our Board of Directors. We recognize that just as the low downpayment, long-term mortgage was necessary for dealing with the realities of the 1930's and the next thirty years, some alternative mortgage forms may require development in order to deal with the economic realities confronting today's home buyer.

We should like to make one comment about S. 664. We see no need to lock into the statute a requirement for a minimum 10% downpayment. While such a requirement may be needed in certain cases, it would be

better to leave it to administrative descretion as S. 1078 would do.

With respect to the Individual Housing Accounts provision of S. 664, our Board of Directors at its meeting in January endorsed enactment of such a provision. (See Attachment A). This matter, we assume, will also require favorable action by the Senate Finance Committee. As you know, a number of proposals were made last year in connection with the Tax Reform Act for ending the interrelationship between tax law and housing. Fortunately, Senators Sparkman, Tower, Brooke and some of the other co-sponsors of S. 664 were able to persuade the Senate and the Congress of the need to provide the housing industry with the ability to attract equity capital through means of the tax law.

Further reform of the tax code seems to be high on the Administration's list of priorities. We urge this Subcommittee to recommend specifically to the Finance Committee, early consideration of S. 664 and other types of tax proposals that will assist in providing a readily available supply of capital for home mortgagors. An example of a related item that might be considered is an NAHB supported proposal for requiring pension funds to increase their present minimal investment in residential mortgages to 20 percent of assets over the next 10-year period.

In conclusion, let me sketch out for you the details of NAHB's Common Sense Housing Subsidy Program, which we believe can complement the

proposals under consideration today.

Actually, our proposal is for two programs. The first would provide assistance for the purchase of up to 100,000 new or substantially rehabilitated units each year in inner city neighborhoods. The second would provide assistance for the purchase of up to 300,000 such units each year in other urban and suburban areas. To encourage the provision of housing in inner city neighborhoods, the terms would be somewhat more lenient and the program would be available to anyone regardless of income. Under the second program, a family could not have an income in excess of 150 per cent of the median income for its area.

Both programs provide assistance through the means of reducing mortgage interest rates by up to 3 per cent, but not below 6 per cent, depending upon the purchase price of the home. The higher the price of the home, the smaller would be the assistance, with a maximum purchase price of $50,000 in keeping with the program's goal of assisting middle-income families.

Under both programs the Government would recapture the assistance upon the sale of the house to the extent that there were sufficient proceeds. Because we look upon the program as a permanent one to be used regardless of other economic conditions, this recapture aspect should ultimately result in the program being viturally self-sustaining in later years. A detailed description of the program is attached to your statement.

Thank you for this opportunity to appear today.

ATTACHMENT "A"

NAHB RESOLUTION

January 25, 1977
Dallas, Texas

COMMITTEE ON CONVENTIONAL HOUSING

INDIVIDUAL HOUSING ACCOUNT

WHEREAS, the increased costs of housing have required a continuing escalation in the size of down payments, and

WHEREAS, the inflation rate in recent years has eroded the ability of potential home buyers to accumulate down payments sufficient to purchase their first home, and

WHEREAS, legislation has been proposed to create Individual Housing Accounts (IHA) that would make available a total of $10,000 in 10 years to set aside sufficient savings for a down payment,

NOW, THEREFORE, BE IT RESOLVED, that NAHB seek and support legislation which would provide a deduction from taxable income for deposits to interest bearing accounts which are established for use as the down payment on a first home.

APPROVED BY THE BOARD OF DIRECTORS

HIGHLIGHTS OF NAHB COMMON SENSE HOUSING SUBSIDY PROGRAM

---Two programs. The first would provide assistance for the purchase of up to 100,000 housing units per year and would be aimed at providing housing in inner-city neighborhoods. The second would provide assistance for the purchase of up to 300,000 units per year and be basically directed toward suburban areas, but would not be so limited.

---Both programs would provide assistance in connection with new or substantially rehabilitated single-family homes or condominium units.

---Under each program the units authorized annually would be allocated as follows:

PURCHASE PRICE	PERCENTAGE OF UNITS
0-$25,000	10%
25,001 - 30,000	20%
30,001 - 35,000	20%
35,001 - 40,000	20%
40,001 - 45,000	20%
45,001 - 50,000	10%

---Under each program the initial mortgage interest rate would be based upon the purchase price of the home. This interest rate would remain unchanged under the inner-city program, but under the suburban program would increase by 1/4% per annum, until the market interest rate in effect at the time the mortgage was written was reached.

---The initial mortgage interest rate would be calculated by reducing the market interest rate by the interest percent established for the purchase price category in which the home falls, but in no case below 6%. The reduction by purchase price category is as follows:

PURCHASE PRICE	INTEREST PERCENT REDUCTION
0-$25,000	3 %
25,001 - 30,000	2 3/4%
30,001 - 35,000	2 1/2%
35,001 - 40,000	2 1/4%
40,001 - 45,000	2 %
45,001 - 50,000	1 3/4%

---In the case of the inner-city program, there would be a one-time front-end payment to the lender, based on an expected average mortgage maturity of 12 years, to compensate for the lower interest rate carried by the mortgage.

For the suburban program, an annual payment would be made to the lender in an amount equal to the difference between what the mortgage payments for principle and interest would have been if the mortgage carried the market interest rate in effect at the time the mortgage was written and the principle and interest payments paid pursuant to the reduced mortgage interest rate for that year.

---To be eligible for assistance under the suburban program, a family's income may not exceed 150% of the median for its area. There would be no income limit for the inner-city program.

---Under both programs, the borrower would be required to repay the subsidy paid on his behalf by the government at the time he sold the house, to the extent that his sales proceeds were sufficient. The mortgage would be assumable through the first 12 years after it is written, with the assumer to repay any subsidy attributable to his period of ownership.

---Only conventionally financed mortgages would be eligible under either program.

---Both programs would be run by GNMA.

February 23, 1977

HOME PURCHASE ASSISTANCE ACT OF 1977

This Act is designed to provide housing for middle-income families at affordable terms. Because of high mortgage interest rates, an increasing number of middle-income families who could have afforded to buy their own home in the past can no longer do so. This Act would authorize the Government National Mortgage Association (GNMA) annually to provide Federal assistance for the purchase of 400,000 new or substantially rehabilitated homes. The assistance would be in the form of payments to lenders to lower the homeowners' mortgage interest rate.

The Act would provide for two programs. In recognition of the fact that many American families prefer to live in urban neighborhoods but that these neighborhoods often lack decent, newly constructed or substantially rehabilitated housing, the first program would provide annual assistance for the purchase of 100,000 homes in older, urban neighborhoods. These neighborhoods would be those designated by the governing body of the unit of general local government, pursuant to regulations issued by the Secretary of HUD. These regulations would set guidelines for the types of neighborhoods that would qualify, e.g., age of present housing stock and potential long-term availability. They would also prescribe the nature of the commitments that the governing body would have to undertake, in connection with its designation of the neighborhood, for the upgrading and maintenance of public facilities and services in the neighborhood. In recognition of the importance of maintaining the vitality of these neighborhoods with a diverse population, there would be no income limits on those eligible for assistance and the assistance would be more generous than that available under the second program.

The second program would provide annual assistance for the purchase of 300,000 homes in other urban or suburban areas. Only families with incomes at or below 150% of the area's median income would be eligible. Family income would be determined as under the 235 program.

Both programs would cover new and substantially rehabilitated single-family homes and condominium units costing $50,000 or less ($62,500 in Alaska, Guam and Hawaii). The dwelling unit must be occupied by the purchaser as his principal residence. Only conventionally financed mortgages would be eligible for this assistance.

In each program the amount of the assistance would depend on the secondary market interest rate in effect at the time the mortgage is executed and the purchase price of the home.

The market interest rate used to determine the amount of assistance would be the average yield (adjusted to the nearest one-quarter percent) for the preceding three months of four-month commitments issued by the Federal National Mortgage Association in its conventional secondary market operations. This rate will be determined by GNMA and published on the first of each month.

The percentage by which the mortgage interest would be reduced from the secondary market rate would be scaled according to the purchase price. The maximum assistance payment would be sufficient to lower the mortgage interest rate by three percentage points, but not below a rate of 6%:

PURCHASE PRICE	INTEREST PERCENT REDUCTION
$0 - $25,000	3%
25,001 - $30,000	2 3/4%
30,001 - 35,000	2 1/2%
35,001 - 40,000	2 1/4%
40,001 - 45,000	2%
45,001 - 50,000	1 3/4%

The differential in interest rates among different purchase price categories would always be maintained, regardless of the market interest rate. For instance, if the market interest rate was 8 1/2%, the reduction for a home purchased at a price of $25,000 or less would only be 2 1/2%, to the 6% floor, and the reduction for a home purchased at a price between $35,001 and $40,000 would be 1 3/4%, rather than 2 1/4%, to a rate of 6 3/4%.

The manner in which the assistance payment would be provided under the two programs is different. Under the first program of assistance in purchasing homes in older, urban neighborhoods the mortgage would be written with an interest rate as determined above. To compensate the lender for the below-market interest rate, GNMA would make a one-time, front-end payment to the lender within 30 days after the execution of the mortgage. The payment would be in an amount equal to the difference between the principal amount of the mortgage and the amount which would be paid for the mortgage if it were priced to provide a yield equal to the secondary market interest rate in effect for the month in which the mortgage is executed. In calculating such yield, GNMA would assume that the life of the mortgage will be 12 years. There would be no change in the mortgage interest rate over the life of the mortgage.

Under the second program the mortgage would carry an initial interest rate as determined above. This interest rate would increase 1/4% per year thereafter, until it reached the secondary market interest rate in effect for the month in which the mortgage was executed. From that time on the mortgage would carry that secondary market interest rate. An annual payment would be made to the lender to compensate for the lower interest rate in an amount equal to the difference between the total amount of principal and interest due under the mortgage for the year and the amount of principal and interest which would have been due for that year if the interest rate on the mortgage was equal to the secondary market rate in effect for the month in which the mortgage was executed.

Under each program the home owner would be required to execute a second mortgage, in favor of the United States, pledging repayment of the assistance payments made on his behalf by GNMA. This second mortgage would be due at the time the property is transferred or the mortgage retired, whichever occurs first. In the event of a sale or other disposition, the amount the home owner would be required to repay could not exceed the gain realized. The definition of gain would be the same as found in Section 1001 of the Internal Revenue Code for determining gain or loss upon the sale of property. In addition, allowances for selling expenses, as set forth in Section 1034 (b) of the Internal Revenue Code, would be permitted.

Thus, if the assistance payments made on behalf of a home owner amounted to $2,000 and she realized from the sale of her home only $1,000, after deducting the real estate commission and other selling expenses and allowing for improvements made to the property, she would only be required to repay the $1,000. In addition, the second mortgage would be satisfied and she would have no further obligation to GNMA.

Mortgage loans assisted under this Act would be assumable by subsequent purchasers at any time during the twelve years following the execution of the mortgage, provided the new home owner agrees to repay that portion of the assistance payments attributable to his period of ownership. In the case of the program for older, urban neighborhoods, the amount would be that portion of the one-time payment allocated by GNMA to the new home owner. Under the second program, it would be the amount of assistance payments made after the assumption. The assumer would be required to execute a new second mortgage to assure repayment, which would not be required to exceed the gain realized at the time of his subsequent sale or transfer of the property.

GNMA would issue to builders prior to or during the construction or rehabilitation of eligible units commitments to make assistance payments. These commitments would be for one year, with one six-month extension permitted. A fee of up to 1%, based on the maximum sales price of the dwelling units for which the commitment is issued, could be charged plus 1/4% for a six-month extension.

GNMA could issue a commitment for a maximum of 100 units to any one builder under the older, urban neighborhood program at any one time. For the second program the maximum commitment would be 50 units. However, builders would be eligible for separate maximum commitments in each standard metropolitan statistical area in which they are building. Furthermore, a builder, who has entered into sales contracts for 50% or more of the dwelling units covered by his commitment, may receive an additional commitment equal to the number of units on which he has sales contracts. The units covered by a commitment would be by purchase price category and a single commitment could include units in more than one category.

Although the number of units authorized for assistance each year could not exceed 100,000 and 300,000 under the two programs, respectively, the actual number that could be assisted in any one year could not exceed the number authorized in appropriations acts for that year. Of the number of units approved for assistance in each year, they would be allocated by unit purchase price as follows:

PURCHASE PRICE	PERCENTAGE OF UNITS
$0 - $25,000	10%
25,001 - 30,000	20%
30,001 - 35,000	20%
35,001 - 40,000	20%
40,001 - 45,000	20%
45,001 - 50,000	10%

These purchase price categories may be increased by up to 25% for units located in Alaska, Hawaii and Guam.

A BILL

TO provide mortgage credit assistance to middle-income families purchasing conventionally financed new and substantially rehabilitated homes and to facilitate the preservation and renewal of urban neighborhoods.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

That this Act may be cited as the "Home Purchase Assistance Act of 1977".

FINDINGS AND PURPOSE

SEC. 2.(a) The Congress finds --

(1) that many middle-income families, who in the past could afford to purchase a newly constructed or substantially rehabilitated house, and make mortgage payments thereon with a reasonable portion of their income, are now unable to afford such a purchase because of high mortgage interest rates;

(2) that urban neighborhoods offer living environments that are preferable to many American fmilies, but that these neighborhoods need the availability of decent, newly constructed or substantially rehabilitated housing that can be afforded by middle-income families; and

(3) that it is the policy of the United States to encourage private enterprise to assume the predominant responsibility for attaining the National goal of a decent home and a suitable living environment for every American family.

(b) It is therefore the purpose of this Act to authorize the Secretary of Housing and Urban Development to direct the Government National Mortgage Association to enter into contracts for mortgage assistance payments to enable middle-income families to finance the purchase of new or substantially rehabilitated housing within their financial means.

MORTGAGE CREDIT ASSISTANCE FOR MIDDLE-INCOME FAMILIES

SEC. 3. Title III of the National Housing Act is amended by adding three new sections as follows:

"Homeownership for Middle-Income Families

"Sec. 314.(a) The Secretary is authorized to direct the Association to make, and to contract to make, mortgage credit assistance payments to lenders who agree to make home mortgage loans to middle-income families meeting the requirements specified in this section.

"(b) To qualify for mortgage credit assistance under this section-

(1) a family's income (as defined in section 235 (i)) at the time of initial occupancy shall not exceed 150 per centum of the median income for the area, as determined by the Secretary with adjustments for smaller and larger families;

(2) the mortgage shall not be insured under the National Housing Act nor guaranteed under Chapter 37 of title 38, United States Code; and

(3) the mortgage loan shall be for the purpose of assisting in the purchase of a newly constructed or substantially rehabilitated single-family dwelling (or of a single-family dwelling unit in a newly constructed or

substantially rehabilitated condominium project) that is to be owned and occupied by the buyer as his principal residence and the sales price of which does not exceed $50,000 ($62,500 in Alaska, Hawaii, and Guam).

"(c) A mortgage assisted under this section shall bear an initial interest rate, based on the purchase price of the dwelling unit and on the secondary market rate for the month in which the mortgage is executed, calculated as follows:

"(1) for dwelling units with a purchase price not in excess of $25,000 the greater of 6 per centum or the secondary market rate minus 3 per centum;

"(2) for dwelling units with a purchase price in excess of $25,000 but not in excess of $30,000, the greater of 6 1/4 per centum or the secondary market rate minus 2 3/4 per centum;

"(3) for dwelling units with a purchase price in excess of $30,000 but not in excess of $35,000, the greater of 6 1/2 per centum or the seondary market rate minus 2 1/2 per centum;

"(4) for dwelling units with a purchase price in excess of $35,000 but not in excess of $40,000, the greater of 6 3/4 per centum or the secondary market rate minus 2 1/4 per centum;

"(5) for dwelling units with a purchase price in excess of $40,000 but not in excess of $45,000, the greater of 7 per centum or the secondary market rate minus 2 per centum; and

"(6) for dwelling units with a purchase price in excess of $45,000 but not in excess of $50,000, the greater of 7 1/4 per centum or the secondary market rate minus 1 3/4 per centum.

The foregoing purchase price limits may be increased by up to 25 per centum for dwelling units located in Alaska, Hawaii and Guam.

For the purposes of this section, the secondary market rate for any month shall be the average yield (adjusted to the nearest one-quarter per centum) for the preceding three months of four-month commitments issued by the Federal National Mortgage Association in its conventional secondary market operations under section 304, as determined by the Government National Mortgage Association and published on the first day of each month.

"(d) The initial interest rate on each mortgage assisted under this section shall be increased annually by one-quarter per centum on the anniversary date of the execution of the mortgage until the mortgage interest rate equals the secondary market rate in effect for the month in which the mortgage was originally executed.

"(e) With respect to each mortgage assisted under this section, the Association shall make an annual mortgage credit assistance payment to the lender on behalf of the eligible family. The payment shall be in an amount equal to the difference between the total amount of principal and interest due under the mortgage for the year, and the amount of principal and interest which would have been due under the mortgage for the year if the mortgage interest rate on such mortgage was equal to the secondary market rate in effect for the month in which the mortgage was executed.

"(f) To qualify for mortgage credit assistance payments-

"(1) The mortgagor shall execute, in favor of the United States, a second mortgage on the property pledging the repayment of the aggregate amount of the mortgage credit assistance payments made on his behalf by the Association.

"(2) The second mortgage shall be due and payable at the time title to the property is transferred as a result of a sale or other disposition or at the time at which the home mortgage is retired, whichever first occurs. The amount of the mortgage credit assistance payments required to be repaid under the second mortgage, in the event of the sale or other disposition of the property, shall not exceed the amount of gain realized upon such sale or disposition. For the purpose of this section, "gain" shall have the same meaning as in section 1001 of the Internal Revenue Code of 1954 with adjustments being made for selling expenses as defined in section 1034(b) of said Code.

"(3) A mortgage loan assisted under this section shall be assumable at any time during the twelve-year period subsequent to the execution of the mortgage: Provided, That each such assumer executes in favor of the United States a second mortgage pledging the repayment, as set out in paragraph (2), of the aggregate amount of the mortgage credit assistance payments made on his behalf by the Association.

"(g) (1) Commitments to make mortgage credit assistance payments may be issued by the Association to a builder prior to or during the construction or rehabilitation of any dwelling units meeting the requirements of subsections (b) and (c). The Association is authorized to charge a commitment fee, not

to exceed one per centum, based on the maximum sales prices of the dwelling units for which the commitment is issued pursuant to the purchase price categories as set out in subsection (h). The term of any commitment shall be for a period of one year and may be extended for an additional six-month period on the payment of an additional commitment fee of not in excess of 1/4 per centum.

"(2) The Association may issue a commitment for no more than a maximum of 50 dwelling units to any one builder at any one time: Provided, That, when a builder has entered into sales contracts for 50 per centum or more of the dwellings units covered by his commitment, he shall be entitled to a commitment for additional dwelling units, but in no case may the number of additional units covered by a commitment, plus the number of dwelling units remaining unsold under the previous commitment, exceed the maximum limit of 50 dwelling units per builder; and Provided further, That a builder may receive separate commitments of up to fifty units for each standard metropolitan statistical area in which he is building.

"(h) Commitments issued in each fiscal year pursuant to this section shall not exceed the number of dwelling units authorized in appropriations acts, but in no event more than 300,000 units per year, and the dwelling units available for commitment in each fiscal year shall be allocated on the basis of purchase price as follows:

"(1) for dwelling units with a purchase price not in excess of $25,000, 10 per centum;

"(2) for dwelling units with purchase prices in excess of $25,000 but not in excess of $30,000, 20 per centum;

"(3) for dwelling units with purchase prices in excess of $30,000 but not in excess of $35,000, 20 per centum;

"(4) for dwelling units with purchase prices in excess of $35,000 but not in excess of $40,000, 20 per centum;

"(5) for dwelling units with purchase prices in excess of $40,000 but not in excess of $45,000, 20 per centum; and

"(6) for dwelling units with purchase prices in excess of $45,000 but not in excess of $50,000, 10 per centum.

The foregoing purchase price limits may be increased by up to 25 per centum for dwelling units located in Alaska, Hawaii, and Guam.

"Urban Homeownership Program

"Sec. 315 (a) In order to encourage stability of older urban neighborhoods, the Secretary is authorized to direct the Association to make, and to contract to make, mortgage credit assistance payments to lenders who agree to make home mortgage loans to middle-income families meeting the requirements specified in this section.

"(b) To qualify for mortgage credit assistance under this section -

"(1) the mortgage shall not be insured under the National Housing Act nor guaranteed under Chapter 37 of title 38, United States Code;

"(2) the mortgage loan shall be for the purpose of assisting in the

purchase of a newly constructed or substantially rehabilitated single-family dwelling (or of a single-family dwelling unit in a newly constructed or substantially rehabilitated condominium project) that is to be owned and occupied by the buyer as his principal residence and the sales price of which does not exceed $50,000 ($62,500 in Alaska, Hawaii and Guam); and

"(3) the dwelling unit shall be located in an older urban neighborhood, as designated by the governing body of the unit of general local government pursuant to regulations issued by the Secretary.

"(c) A mortgage assisted under this section shall bear an initial interest rate, based on the purchase price of the dwelling unit and on the secondary market rate for the month in which the mortgage is executed, calculated as follows:

"(1) for dwelling units with a purchase price not in excess of $25,000 the greater of 6 per centum or the secondary market rate minus 3 per centum;

"(2) for dwelling units with a purchase price in excess of $25,000 but not in excess of $30,000, the greater of 6 1/4 per centum or the secondary market rate minus 2 3/4 per centum;

"(3) for dwelling units with a purchase price in excess of $30,000 but not in excess of $35,000, the greater of 6 1/2 per centum or the secondary market rate minus 2 1/2 per centum;

"(4) for dwelling units with a purchase price in excess of $35,000 but not in excess of $40,000, the greater of 6 3/4 per centum or the secondary market rate minus 2 1/4 per centum;

"(5) for dwelling units with a purchase price in excess of $40,000 but not in excess of $45,000, the greater of 7 per centum or the secondary market rate minus 2 per centum; and

"(6) for dwelling units with a purchase price in excess of $45,000 but not in excess of $50,000, the greater of 7 1/4 per centum or the secondary market rate minus 1 3/4 per centum.

The foregoing purchase price limits may be increased by up to 25 per centum for dwelling units located in Alaska, Hawaii and Guam.

For the purposes of this section, the secondary market rate for any month shall be the average yield (adjusted to the nearest one-quarter per centum) for the preceding three months of four-month commitments issued by the Federal National Mortgage Association in its conventional secondary market operations under section 304, as determined by the Government National Mortgage Association and published on the first day of each month.

"(d) With respect to each mortgage assisted under this section, the Association shall make a mortgage credit assistance payment to the lender on behalf of the eligible family within thirty days after the execution of the mortgage. The payment shall be in an amount equal to the difference between the principal amount of the mortgage and the amount which would be paid for the mortgage if it were priced to provide a yield equal to the secondary market rate in effect for the month in which the mortgage was executed. In calculating such yield, the Association shall assume that the life of the mortgage will be twelve years.

"(e) (1) To qualify for a mortgage credit assistance payment, the mortgagor shall execute, in favor of the United States, a second mortgage on the property pledging the repayment of the amount of the mortgage credit assistance payment made on his behalf by the Association.

"(2) The second mortgage shall be due and payable at the time title to the property is transferred as a result of a sale or other disposition or at the time at which the home mortgage is retired, whichever first occurs. The amount of the mortgage credit assistance payment required to be repaid under the second mortgage, in the event of the sale or other disposition of the property, shall not exceed the amount of gain realized upon such sale or disposition. For the purposes of this section, "gain" shall have the same meaning as in section 1001 of the Internal Revenue Code of 1954 with adjustments being made for selling expenses as defined in section 1034(b) of said Code.

"(3) A mortgage loan assisted under this section shall be assumable at any time during the twelve-year period subsequent to the execution of the mortgage: Provided, That each such assumer executes in favor of the United States a second mortgage pledging the repayment, as set out in paragraph (2), of the proportionate amount of the mortgage credit assistance payment made by the Association with respect to the mortgage for the period of his ownership of the property. In the case of such an assumption, the original or a subsequent mortgagor shall only be required to repay that part of the mortgage credit assistance payment which is proportionate to the period of his ownership of the property. The amount of any proportionate repayment shall be determined by the Association.

"(f) (1) Commitments to make mortgage credit assistance payments may be issued by the Association to a builder prior to or during the construction or rehabilitation of any dwelling units meeting the requirements of sub-

sections (b) and (c). The Association is authorized to charge a commitment fee, not to exceed one per centum, based on the maximum sales price of the dwelling units for which the commitment is issued pursuant to the purchase price categories as set out in subsection (g). The term of any commitment shall be for a period of one year and may be extended for an additional six-month period on the payment of an additional commitment fee of not in excess of 1/4 per centum.

"(2) The Association may issue a commitment for no more than a maximum of 100 dwelling units to any one builder at any one time: Provided, That, when a builder has entered into sales contracts for 50 per centum or more of the dwelling units covered by his commitment, he shall be entitled to a commitment for additional dwelling units, but in no case may the number of additional units covered by a commitment, plus the number of dwelling units remaining unsold under the previous commitment, exceed the maximum limit of 100 dwelling units per builder: and, Provided further, That a builder may receive separate commitments of up to 100 dwelling units for each standard metropolitan statistical area in which he is building.

"(g) Commitments issued in each fiscal year pursuant to this section shall not exceed the number of dwelling units authorized in appropriations acts, but in no event more than 100,000 units per year, and the number of dwelling units available for commitment in each fiscal year shall be allocated on the basis of purchase price as follows:

"(1) for dwelling units with a purchase price not in excess of $25,000, 10 per centum;

"(2) for dwellings units with purchase prices in excess of $ 25,000 but not in excess of $30,000, 20 per centum;

"(3) for dwellings units with purchase prices in excess of $30,000 but not in excess of $35,000, 20 per centum;

"(4) for dwelling units with purchase prices in excess of $35,000 but not in excess of $40,000, 20 per centum;

"(5) for dwelling units with purchase prices in excess of $40,000 but not in excess of $45,000, 20 per centum; and

"(6) for dwelling units with purchase prices in excess of $45,000 but not in excess of $50,000, 10 per centum.

The foregoing purchase price limits may be increased by up to 25 per centum for dwelling units located in Alaska, Hawaii, and Guam.

"Sec. 316. (a) To carryout the purposes of Section 314 and Section 315, the Association is hereby authorized to enter annually into mortgage credit assistance payment contracts to assist not more than 300,000 units pursuant to Section 314 (h) and not more than 100,000 units pursuant to Section 315 (g) for each fiscal year commencing after September 30, 1977.

"(b) To provide for the payment of mortgage credit assistance payment contracts authorized in subparagraph (a), there is authorized to be appropriated for each fiscal year commencing after September 30, 1977, such sums, not in excess of $_______ for any such fiscal year, as may be necessary to carryout the provisions of Section 314 and Section 315."

The CHAIRMAN. Thank you very much, Mr. Arquilla.
Mr. Hanrahan.

STATEMENT OF DANIEL C. HANRAHAN, CHAIRMAN, LEGISLATIVE COMMITTEE, NATIONAL ASSOCIATION OF REALTORS, ACCOMPANIED BY ALBERT E. ABRAHAMS, STAFF VICE PRESIDENT, GOVERNMENT AFFAIRS

Mr. HANRAHAN. Mr. Chairman, I will curtail some of my written statement but I understand that the full statement will be a matter of record. Is that correct?

The CHAIRMAN. Yes.

Mr. HANRAHAN. Thank you very much.

[Complete statement follows:]

REALTOR®

NATIONAL ASSOCIATION OF REALTORS

Harry G. Elmstrom, President — H. Jackson Pontius, Executive Vice President

Albert E. Abrahams, Staff Vice President

Government Affairs

925 15th Street, Washington, D.C. 20005

Telephone 202 628 5300

STATEMENT OF

DANIEL C. HANRAHAN

Chairman of the REALTORS® LEGISLATIVE COMMITTEE

NATIONAL ASSOCIATION OF REALTORS

Before the Senate Committee on Banking, Housing And Urban Affairs

Legislative Hearings on S.1078 and S.664

March 31, 1977

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,700 local boards of REALTORS® located in every state of the Union, the District of Columbia and Puerto Rico. Combined membership of these boards is in excess of 500,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The Association has the largest membership of any association in the U.S. concerned with all facets of the real estate industry. Principal officers include: Harry G. Elmstrom, President, Ballston Spa, New York; Tom Grant, Jr., Vice President, Tulsa, Oklahoma; and H. Jackson Pontius, Executive Vice President. Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington office is located at 925 - 15th Street, N.W., Washington, D.C. 20005. Telephone 202/628-5300.

Introduction

Mr. Chairman, and members of the Committee --

My name is Dan Hanrahan, I am a Realtor® from Elizabeth, New Jersey, and presently serve as Chairman of the REALTORS® Legislative Committee. I am here this morning representing the five hundred thousand REALTORS® of America who belong to more than seventeen hundred Boards of Realtors and fifty State Associations.

Mr. Chairman, we are pleased to appear here today in basic support of the concepts contained in S.1078 and in the "Young Families' Housing Act of 1977", S.664. These bills provide for such improvements in mortgage finance as expanding the scope of the present experimental program for Federally-insured graduated payment mortgages and providing for the creation of Individual Housing Accounts.

We wish to commend the foresight of Chairman Proxmire and Senator Brooke in introducing such innovative legislation.

Section 245 of the National Housing Act provides for a program of Federally-insured mortgage loans of varying rates of amortization on an experimental basis. Both S.1078 and the "Graduated Payment Mortgage Insurance Act", Section 2 of S.664, would amend Section 245 as follows:

1. The program would be changed from an experimental to a permanent basis.
2. The outstanding principal balance on such mortgage loans may not at any time exceed 97% of appraised value (unless the borrower is a veteran whose mortgage loan is insured under a provision of Section 203 permitting lower downpayments).

3. Such mortgage loans would not be subject to State laws limiting the amount of interest which may be charged, or the manner of calculating such interest (including the prohibition against the charging of interest on interest), if such State laws would not apply to the mortgage loan in the absence of graduated payment mortgage provisions.

4. In addition, S.664 would also require that the downpayment on such mortgage loans shall be at least 10%.

Section 3 of S.664, the "Individual Housing Account Act", would amend the Internal Revenue Code of 1954 by allowing for the creation of individual housing accounts which are in the nature of the existing Individual Retirement Accounts. The Individual Housing Account legislation would permit deductions of up to $2,500 for any taxable year for amounts placed in a special account. The maximum which may be set aside in such accounts is $10,000. Interest earned on these deposits is not taxed. Both of these special tax treatments are allowed if the funds are used for the purchase of a principal residence. If the funds are not so used, penalties are imposed under this legislation.

As Senator Brooke pointed out when introducing S.664, the escalating cost of housing threatens our traditional American dream and goal of homeownership. As the real estate professionals in constant contact with both homebuyers and homeowners, the members of our Association know only too well the increasing difficulties which face families - particularly young families - in their attempts to achieve their dream of owning their own home. The provisions provided for in S.1078 and in S.664 will help alleviate these difficulties, and therefore, this

Association urges the Committee to seriously consider this proposed legislation.

GRADUATED PAYMENT MORTGAGES

This Association strongly supports the concept of developing alternative mortgage instruments to better satisfy the differing needs of various segments of our society. The fixed-rate, fixed-payment mortgage that has been the hallmark of mortgage finance for more than 40 years needs to be seriously reexamined in light of its ability to satisfy these differing needs.

One example of a flexible-payment mortgage that has shown to be very popular in its few short months of existence are HUD's graduated payment mortgage plans. By a program of graduated mortgage payments tying the monthly payment to family income, the government's willingness to guarantee the success of such a program should encourage homeownership for many Americans now unable to afford it.

This plan enables young families to purchase the home of their choice much sooner than would normally be the case, yet without obligating themselves to a debt that would be difficult, if not impossible, to repay. Under the plan, monthly payments for principal and interest in the first year are as much as 25 percent below what they would otherwise be under a traditional level payment mortgage.

Alternative payment plans, however, must also be well grounded financially to assure a viable program. HUD's Graduated Mortgage Payment (GMP) Plan fills this objective. The GMP plan operates within well constrained and well defined bounds and avoids many of the pitfalls that are sometimes evidenced in other alternative mortgage instrument proposals, as outlined in Attachments 1, 2 and 3.

However, even the Graduated Mortgage Payment Plans are not completely devoid of potential problems. Mortgage plans which seek to "qualify buyers" by lowering the intial monthly payments could carry a higher risk of delinquencies

and default than traditional level payment mortgages do. That risk can be minimized if the payment schedule increases at a moderate rate and if underwriting procedures are developed to identify fully qualified buyers whose income will most likely keep pace with the programmed increase in monthly payments.

Generally, annual increases in the monthly payment schedule of 5 percent or less (typical of 4 of the HUD plans) should not pose an unmanageable burden on most homebuyers. In most cases, incomes will keep pace or out-strip these increases. However, to avoid an unacceptable rise in delinquencies, special care should be used in qualifying buyers for GMP mortgages which carry a 7½ percent or higher rate of graduation. At the present time, the underwriting requirements for mortgages insured under Section 245 are apparently the same as those specified for the Section 203(b) and 234(c) programs.

While this Association, therefore, basically supports the current Graduated Payment Mortgage, the majority of the amendments offered in S.1078 and in S.664 do, in our opinion, perfect the existing legislation, and we submit the following observations:

1. This Association strongly endorses the provision to convert the Section 245 experiment to a permanent program and remove the one percent limitation of HUD's insuring capacity designated for the Graduated Mortgage Payment Program. Under the current law, only a few thousand units can be insured under the graduated mortgage payment plan. We concur that if this program is really to be allowed to work, such constraints must be removed.
2. Similarly, to assure maximum possible availability of the program to homebuyers across the country, regardless of where they live, we support the concept that State usury laws are unduly restrictive in times of tight money. We, therefore, feel that mortgages on single-family dwellings could be best served by the provision to offset such State laws which set maximum interest rates charged and/or prohibit the charging of interest on interest, if such laws would not apply to the mortgage in the absence of such graduated payment mortgage provisions.

88-114 O - 77 - 10

3. With the removal of the one percent limitation, however, emphasis should be given to more stringent underwriting standards. Until the present time, the criteria applied to the 245 program have been the same as those used for the 203(b) program. We recognize the desirability of this mode of operation during the experimental period of the program, since it was necessary to document the underlying causes engendering successes and failures. Full implementation of the program requires more cautious procedures be put into effect. Chances of default and foreclosure are increased considerably with the neglect to consider future earning power of potential borrowers as well as forecasted appreciation of the properties to be insured. Care must be taken to minimize undue potential drain on the FHA insurance fund.

   We do feel, however, that these concerns can better be handled by more careful monitoring of the programs to identify and prevent abuses than by raising the downpayment on Section 245 mortgages to 10% as proposed in S.664. Young families today have a difficult enough time raising the required downpayment on the ever increasing cost of housing.

4. We support the limit of 97% of appraised value. While the current GPM offers five alternative plans, the one most widely picked by borrowers is the one providing for an annual 7.5% increase in the amount of payments for the first five years. Unfortunately, this is also the plan which results in the highest principal amount. (An analysis of these plans is contained in Attachment 2.)

In short, Mr. Chairman, this Association is on record as endorsing Section 245 as a positive step toward benefiting young families and first-time homebuyers who cannot now afford housing because of high monthly mortgage payments. We appreciate and commend the interest this Committee has shown in strengthening this program.

INDIVIDUAL HOUSING ACCOUNTS

The "Young Families' Housing Act of 1977" also provides for the establishment of an Individual Housing Account (IHA). This provision is designed to help potential homebuyers by creating tax incentives which assist individuals in accumulating savings for the downpayment on a home. The National Association of REALTORS® supports the objectives of such incentives.

The concept of the Individual Housing Account is a well-placed step in the right direction. While the National Association of REALTORS® supports the objective of aiding potential homebuyers, we would like to briefly indicate certain questions about the Individual Housing Account provisions which this Committee may wish to consider:

1. The deduction of up to $2,500 per year which is provided for in this bill would be claimed as an itemized deduction on the individual's tax return. By its nature, this provision will be of less benefit to certain taxpayers than to others. For example, if a taxpayer presently has very small itemized deductions, he or she would be better off claiming the standard deduction on his or her tax return. If that person did not set aside the maximum yearly amount allowable for the IHA, he or she may still be better off claiming the standard deduction rather than itemising. Thus, for that person, the bill's allowable deduction provides little benefit that year. Attachment 4 sets forth additional information on this point.

2. If a tax credit is utilized, rather than an itemized deduction, then a benefit will be available to a person whether a standard deduction is used or not. Such a provision, however, would probably be more costly in terms of revenue losses than the present provision.

Even if a deduction is allowed in addition to the standard deduction, (as in the case of Individual Retirement Accounts) this will still be of little benefit to those families who cannot afford to set money aside for the IHA.

3. This bill provides a 10% penalty upon the amount saved if it is not used for the purchase of a principal residence. Unfortunately, this provision would also penalize the person who saved his money in good faith but found, even at the end of the ten years, that his savings were still not sufficient for a downpayment. Thus, when the money is returned, less cash than expected may be actually saved because of the penalty.

4. We understand that the intent of the IHA is to provide an incentive for those wishing to purchase their first principal residence. That is, this provision is not available for those persons who already own a home. It does not appear that the actual legislative language of S.664 spells out that this provision is limited to the purchase of one's <u>first</u> principal residence. Accordingly, a technical change may be appropriate.

<u>Summary</u>

In summary, Mr. Chairman, this Association has long been concerned about the ever increasing difficulties facing <u>all</u> potential homebuyers, but particularly young families, in arranging for mortgage finance. We commend the Committee for its foresight in considering such potential remedies for this problem as contained in S.1078 and S.664.

We appreciate the opportunities to communicate our support and our concerns. Thank you.

ATTACHMENT "1"

ADVANTAGES OF HUD'S GRADUATED PAYMENT MORTGAGE PROGRAM

1. The entire schedule of monthly payments and the outstanding mortgage balance are well defined, and payments under other proposals fluctuate with the inflation rate and are not predictable in advance by both borrower and lender.

2. The initial build-up in mortgage debt is limited, so the homeowner is not accruing a debt of uncertain proportions over the life of the loan.

3. The GPM mortgage payments graduate at a predetermined rate for five or ten years and than convert to a fixed payment schedule. Under most deferred payment-type loan plans, homeowners who stayed with the plan for too long, could be courting personal financial disaster, either through unconscionably high monthly payments or through a huge debt payable upon sale of the home.

4. The "truth-in-lending" aspects of GPM mortgages are far less complicated than other proposals.

5. GPM mortgages should be more readily acceptable in the secondary market. A major drawback of other proposals is their uncertain marketability. As you know, the Federal National Mortgage Association has already announced that these mortgages are eligible for purchase by FNMA.

NATIONAL ASSOCIATION OF REALTORS®
Department of Economic and Research

March 1977

ATTACHMENT "2"

COMPARISON OF STANDARD MORTGAGE PAYMENT
SCHEDULE WITH 10 YEAR GRADUATED MORTGAGE PLAN

$35,000 Loan 8-1/2% Interest 30 Year Term

YEAR	LEVEL PAYMENT LOAN		2.5 PERCENT GRADUATION		3.0 PERCENT GRADUATION
1	$269	Lower	$238	Lower	$223
2	269		242		230
3	269		247		237
4	269		252		244
5	269		257		251
6	269		262		258
7	269		268		266
8	269	Higher	273	Higher	274
9	269		278		282
10	269		283		291
11+	269		290		300

COMPARISON OF STANDARD MORTGAGE PAYMENT
SCHEDULE WITH 5 YEAR GRADUATED MORTGAGE PLAN

$35,000 Loan 8-1/2% Interest 30 Year Term

YEAR	LEVEL PAYMENT LOAN		2.5 PERCENT GRADUATION		5.0 PERCENT GRADUATION		7.5 PERCENT GRADUATION
1	$269	Lower	$245	Lower	$223	Lower	$203
2	269		251		234		217
3	269		257		245		234
4	269		264		258		252
5	269	Higher	270	Higher	271	Higher	271
6+	269		276		284		291

NATIONAL ASSOCIATION OF REALTORS®
Department of Economics and Research

March 1977

OUTSTANDING PRINCIPAL BALANCE UNDER LEVEL
PAYMENT PLAN AND 10 YEAR GMP

$35,000 Loan   8-1/2% Interest   30 Year Term

YEAR	LEVEL PAYMENT LOAN	2.0 PERCENT GRADUATION	3.0 PERCENT GRADUATION
Start			
1	$35,000 X	$35,000	$35,000
2	34,735	35,129	35,311
3	34,447	35,210	35,566
4	34,134	35,238 X	35,758
5	33,792	35,207	35,879
6	33,421	35,210	35,918 X
7	33,017	35,061	35,868
8	32,577	34,831	35,716
9	32,098	34,512	35,451
10	31,577	33,914	35,060
11	31,010	33,369	34,529
12	30,393	32,705	33,841
	29,721	31,982	33,093

OUTSTANDING PRINCIPAL BALANCE UNDER LEVEL
PAYMENT PLAN AND 5 YEAR GMP

$35,000 Loan   8-1/2% Interest   30 Year Term

YEAR	LEVEL PAYMENT LOAN	2.5 PERCENT GRADUATION	5.0 PERCENT GRADUATION	7.5 PERCENT GRADUATION
Start	$35,000 X	$35,000	$35,000	$35,000
1	34,447	35,039 X	35,315	35,564
2	34,134	35,007	35,519	35,988
3	33,792	34,893	35,596 X	36,246
4	33,421	34,688	35,526	36,308 X
5	33,017	34,384	35,289	36,139
6	32,577	33,968	34,862	35,702
7	32,098	33,516	34,398	35,226
8	31,577	33,023	33,892	34,709

X Indicates peak mortgage balance.

NATIONAL ASSOCIATION OF REALTORS®
Department of Economics and Research

March 1977

ATTACHMENT "3"

COMPARISON OF TOTAL MORTGAGE PAYMENTS UNDER STANDARD
MORTGAGE PAYMENT SCHEDULE AND 10 YEAR GRADUATED MORTGAGE PLANS

$35,000 Loan 8-1/2% Interest 30 Year Term

	LEVEL PAYMENT LOAN		2.5 PERCENT GRADUATION		3.0 PERCENT GRADUATION	
YEAR	Annual Total	Cumulative Total	Annual Total	Cumulative Total	Annual Total	Cumulative Total
1	$3,228	$3,228	$2,856	$2,856	$2,676	$2,676
2	3,228	6,456	2,904	5,760	2,760	5,436
3	3,228	9,684	2,964	8,724	2,844	8,280
4	.....	12,912	3,024	11,748	2,928	11,208
5	.....	16,140	3,084	14,832	3,012	14,220
6	.....	19,368	3,144	17,976	3,096	17,316
7	.....	22,596	3,216	21,192	3,192	20,508
8	.....	25,824	3,276	24,468	3,288	23,796
9	.....	29,052	3,336	27,804	3,384	27,180
10	.....	32,280	3.396	31,200	3,492	30,672
11	.....	35,508	3,480	34,680	3,600	34,272
12	.....	38,736	3,480	38,160	3,600	37,872
13	.....	41,964	3,480	41,640	3,600	41,472
14	.....	45,192	.....	45,120	.....	45,072
15	.....	48,420	.....	48,600	.....	48,672
16	.....	51,648	.....	52,080	.....	52,272
17	.....	54,876	.....	55,560	.....	55,872
18	.....	58,104	.....	59,040	.....	59,472
19	.....	61,332	.....	62,520	.....	63,072
20	.....	64,560	.....	66,000	.....	66,672
21	.....	67,788	.....	69,480	.....	70,272
22	.....	71,016	.....	72,960	.....	73,872
23	.....	74,244	.....	76,440	.....	77,472
24	.....	77,472	.....	79,920	.....	81,072
25	.....	80,700	.....	83,400	.....	84,672
26	.....	83,928	.....	86,880	.....	88,272
27	.....	87,156	.....	90,360	.....	91,872
28	.....	90,384	.....	93,840	.....	95,472
29	3,228	93,612	3,480	97,320	3,600	99,072
30	3,228	96,840	3,480	100,800	3,600	102,672

NATIONAL ASSOCIATION OF REALTORS®
Department of Economics and Research
March, 1977

COMPARISON OF TOTAL MORTGAGE PAYMENT UNDER STANDARD
MORTGAGE PAYMENT SCHEDULE AND 5 YEAR GRADUATED MORTGAGE PLANS

$35,000 Loan 8-1/2% Interest 30 Year Term

	LEVEL PAYMENT LOAN		2.5 PERCENT GRADUATION		5.0 PERCENT GRADUATION		7.5 PERCENT GRADUATION	
YEAR	Annual Total	Cumulative Total	Annual Total	Cumulative Total	Annual Total	Cumulative Total	Annual Total	Cumulative Total
1	$3,228	$3,228	$2,940	$2,940	$2,676	$2,676	$2,436	$2,436
2	3,228	6,456	3,012	5,952	2,808	5,484	2,604	5,040
3	3,228	9,684	3,084	9,036	2,940	8,424	2,808	7,848
4	.....	12,912	3,168	12,204	3,096	11,520	3,024	10,872
5	.....	16,140	3,240	15,444	3,252	14,772	3,252	14,124
6	.....	19,368	3,312	18,756	3,408	18,180	3,492	17,616
7	.....	22,596	3,312	22,068	3,408	21,588	3,492	21,108
8	.....	25,824	3,312	25,380	3,408	24,996	3,492	24,600
9	.....	29,052	.....	28,692	.....	28,404	.....	28,092
10	.....	32,280	.....	32,004	.....	31,812	.....	31,584
11	.....	35,508	.....	35,316	.....	35,220	.....	35,076
12	.....	38,736	.....	38,628	.....	38,628	.....	38,568
13	.....	41,964	.....	41,940	.....	42,036	.....	42,060
14	.....	45,192	.....	45,252	.....	45,444	.....	45,552
15	.....	48,420	.....	48,564	.....	48,852	.....	49,044
16	.....	51,648	.....	51,876	.....	52,260	.....	52,536
17	.....	54,876	.....	55,188	.....	55,668	.....	56,028
18	.....	58,104	.....	58,500	.....	59,076	.....	59,520
19	.....	61,332	.....	61,813	.....	62,484	.....	63,012
20	.....	64,560	.....	65,124	.....	65,892	.....	66,504
21	.....	67,788	.....	68,436	.....	69,300	.....	69,996
22	.....	71,016	.....	71,748	.....	72,708	.....	73,448
23	.....	74,244	.....	75,060	.....	76,116	.....	76,980
24	.....	77,472	.....	78,372	.....	79,524	.....	80,472
25	.....	80,700	.....	81,684	.....	82,932	.....	83,964
26	.....	83,928	.....	84,996	.....	86,340	.....	87,456
27	.....	87,156	.....	88,308	.....	89,748	.....	90,948
28	.....	90,384	.....	91,620	.....	93,156	.....	94,440
29	3,228	93,612	3,312	94,932	3,408	96,564	3,492	97,932
30	3,228	96,840	3,312	98,244	3,408	99,972	3,492	101,424

NATIONAL ASSOCIATION OF REALTORS®
Department of Economics and Research
March, 1977

ATTACHMENT "4"

NUMBER OF INDIVIDUAL INCOME TAX RETURNS WITH STANDARD AND ITEMIZED DEDUCTIONS BY INCOME CLASS IN 1973

Returns with Adjusted Gross Income	Number of Returns by Type of Deductions		Percent of Returns Itemized
	Itemized	Standard	
Under $5,000	1,310,626	25,283,389	4.9%
$5,000 - $9,999	5,771,126	14,810,606	28.0
$10,000 - $14,999	7,705,940	8,098,169	48.8
$15,000 - $19,999	6,214,263	2,876,738	68.4
$20,000 - $24,999	3,239,423	704,570	82.1
$25,000 and over	3,806,031	428,103	89.9
Total	28,047,409	52,201,575	35.0%

Source: Statistics of Income 1973 - Individual Income Tax Returns; Department of the Treasury, Internal Revenue Service.

The CHAIRMAN. Thank you, sir.

Mr. Arquilla, you indicated that the National Association of Home Builders does not have a position on the bills before us and that you feel there's need for more study. You say your staff is monitoring the HUD experiment. Can you give us any indication of what the monitoring shows?

Mr. ARQUILLA. We are really waiting, Mr. Chairman, for the statistics to come out from HUD so that we can really put a fix onto it and as yet they have not come out. As a matter of fact, they will be coming out shortly.

The CHAIRMAN. How has HUD's initial effort been viewed by homebuilders?

Mr. ARQUILLA. I think the initial effort is fine. Any way that we can bring in line more young people to be able to afford to buy a home would be to the total country's benefit. We don't feel, however, that we have a fix on it. We are not sure how many people can take advantage of such a program and I can only echo some of the concerns that were mentioned here earlier today by the other panel, whether or not the financial institutions will view this form of mortgage a good one and one that they would want to invest in heavily.

The CHAIRMAN. Let me ask you, Mr. Hanrahan, more than anyone else, the realtor is the frontline person dealing with the home buyer. To a considerable extent the borrowers' attitude toward the GPM will be shaped by the real estate agent's attitude and ability to explain the complexities of the loan. Do you have any evidence of any kind that your members will be able to explain these loans in terms the consumers will truly understand and be able to assess in terms of the benefits and drawbacks to their own interests?

Mr. HANRAHAN. Mr. Chairman, no tangible evidence that I can present to you right now, except to assure you that there's great concern and support for this concept among realtors. We feel it can be done. For example, real estate brokers have successfully explained the more complicated variable rate mortgage to numerous home buyers in California and in New England. It's going to be an educational effort and the National Association has committed itself to initiation of this educational effort. In fact, when the graduated payment mortgage plan was implemented by HUD last year, this association pledged its support in educating the general public on the provisions of the plan, particularly in areas where HUD offices are not located.

The CHAIRMAN. Now you have endorsed the individual housing account. Isn't it true that this tax incentive will reward people in high tax brackets more than it will help people in low tax brackets?

Mr. HANRAHAN. Mr. Chairman, the answer is yes. We don't look upon the IHA as a cure-all for all potential home buyers. We think it has to be looked upon as an important part of an overall program of housing finance which, of necessity, must include the concept of the FHA section 235 and section 8 programs.

The CHAIRMAN. Mr. Arquilla, you're involved and very concerned—I'm sure both you gentlemen are—with the problem of affordability gap in housing, the fact that you both pointed out, and you strongly feel that it's a tragedy that the great majority of the people in this country can't afford to buy a home.

Do you feel there are a considerable number of moderately priced homes available which have difficulty in finding financing? Do you think that the lenders are inclined to make a loan on a larger home rather than a lower priced one when faced with a choice between the two? You might both want to answer that.

Mr. ARQUILLA. Mr. Chairman, I really don't think so. I think that most thrift institutions across the country are very aware of the need for housing and I think they are very aware of the need that they've got to provide mortgages for not only the——

The CHAIRMAN. I don't mean this in any kind of demeaning way at all. If I were in the business I think I'd recognize the fact that when you sell a large home there's more work for the builder, more profit for the builder, more commission for the realtor, and that's right. That's the way our system works. But it's a fact of life that we have to recognize and we have seen the terrific escalation in the cost of the average home as sold now. What is it now, almost $50,000?

Mr. ARQUILLA. Mr. Chairman, we talk about median price and average price and we talk about what's going to happen 10 years down the road and I think I get more scared than the people who are reading it in the newspapers. We have builders across this country who are providing houses that cost $25,000, are successfully providing it, and mortgage companies are coming in and providing them mortgages for those homes. I don't think it's a question of whether there's more profit in providing the mortgage on an $80,000 house over a $30,000 house. I think it's a question of what the builder can provide in a particular area.

Now, unfortunately, we have high cost areas and low cost areas in this country and it's very unfortunate. In the area I come from we can't provide housing for less than $38,000 or $39,000. It's not that we don't want to.

The CHAIRMAN. You put it much better. I didn't mean there weren't areas where you cannot buy homes for $25,000 or $35,000. I had a builder in my office yesterday that's done an excellent job in that respect, but there are many areas where you cannot. That's what I'm concerned about.

Mr. ARQUILLA. In those areas where we cannot, we have a serious problem and we are not taking care of many, many, many of the families who really need housing. If the cost escalations continue we are going to be reducing the amount that we can take care of in the future.

The CHAIRMAN. At any rate, you do not feel that this is a matter of the lenders not being as interested in a more modestly priced home?

Mr. ARQUILLA. No, I do not.

The CHAIRMAN. Would you like to say a word about that, Mr. Hanrahan?

Mr. HANRAHAN. I feel, and our members feel, that this program will really take hold. HUD quickly committed for the approximately 3,000 units allowed under the current section 245 program. We feel in the competitive market the lender will want to make these loans

in order to assure a future clientele. We feel also that the probability of getting the lower price housing unit is more likely in the resale home rather than the new home. There are some homes, of course, where you can develop a new home for this low price. We feel that the section 245 program does not stand alone, but has to be considered with other housing programs.

The CHAIRMAN. You list in the attachment to your statement among the advantages for the GPM that you have a well defined and clear-cut schedule of payments as contrasted with the variable rate mortgage where you wouldn't have that, you don't know what it is. Does that mean you oppose the variable mortgage because of its unpredictability?

Mr. HANRAHAN. Not at all, sir. We feel every instrument should be allowed to be tested in the marketplace and we feel the market is going to indicate very clearly in some period of time, not too long a period of time, whether it will survive. So we think there are circumstances where the variable rate may well apply, but this is a very attractive mortgage instrument we feel.

The CHAIRMAN. Senator Brooke.

Senator BROOKE. Mr. Arquilla, when I introduced this legislation, my primary concern was and still obviously is to benefit first home buyers, particularly young families. This is because I think society really is jeopardized when you don't have young people owning a piece of this country. But I assure you that I also had in mind the construction industry and the homebuilding industry and the real estate industry that were suffering at the time when this was introduced. I would think that this would be helpful to both of you and I understood that your national association did go on record as being in favor of the individual housing account. Is that correct?

Mr. ARQUILLA. That's correct.

Senator BROOKE. I want that clear for the record because I think that it is important that we have your support on the individual housing account. Though you're monitoring the GPM and do not yet have an official position, don't you feel that the GPM would provide a stimulus to the housing industry, especially when we take into account information that in California, under the GNP, the average monthly payment was $45 less than the average monthly payment for a standard FHA mortgage? It seems to me this would open up the market to many families who have been excluded and with no subsidy costs to the taxpayer. The realists in Congress know how difficult it would be to find support for even a shallow subsidy. This bill is an effort to give some relief to that first home buyer at less than extravagant cost to the Federal taxpayer. I'm not saying that I wouldn't favor personally some subsidy for lower mortgage rates, but when you get going down that road you're running into all kinds of obstacles, even with the new administration.

So, in your monitoring, I hope you see that the GPM would be a stimulus to the housing industry.

Mr. ARQUILLA. Senator, perhaps you misunderstand. We have a problem in our organization in that when we come to testify we can only testify to the effect of a policy that's been established by our

board of directors. Our board of directors will be meeting here in May and certainly this is going to be brought to them, and if we can convince them of the merits of your proposal as far as the graduated payment is concerned, I'm certainly sure that we will be coming back and telling you that. But since we don't have the policy, it's impossible for me representing that organization to express agreement or disagreement. We do have policy on the savings plan and so therefore we are in favor of it and we think it's extremely important and would be a very viable tool in bringing in funds into the thrift institutions and yet provide a little help financially to those saving for their first home.

Senator BROOKE. I certainly understand your position and I don't argue with that, but I do know your national organization did go on record in favor of the individual housing account. I hope that when you talk to your board in May that you will point out to them the reality of the problems that we face in this country today.

Mr. ARQUILLA. I certainly will.

Senator BROOKE. Mr. Hanrahan, in your testimony you stress the need for more stringent underwriting standards. Do you have any specific suggestions as to how the existing standards could and should be changed to give the protection against default you feel is necessary?

Mr. HANRAHAN. Since the section 245 program is intended to meet the needs of the homebuyer who has not yet reached his earning capacity, we strongly suggest that underwriters carefully review the mortgage application based on the probability of future income. If, for example, a person is just beginning a career in which the more experienced in that field are compensated at a much higher rate, the mortgage application should be readily approved after applying the 203(b) standards as they relate to the present income and current mortgage payment structure. On the other hand, if someone has been working in a particular field of endeavor for a reasonable length of compensation approximating that reached by most counterparts in that field, another situation exists. In such a case, the mortgage application should be disapproved if the current income is not adequate to cover the higher payment levels of the program.

If such an alternative were implemented, basic guidelines could be issued from HUD's central office; however, local field offices would be called upon to examine the income rates applying to those geographic areas and design the criteria accordingly.

Another possible avenue for circumventing future defaults is to restrict the rate of graduation to 5 percent or less, except in special cases. There are many cases in which the level of income would increase at an adequate rate through cost-of-living allowances or regular merit raises. However, with the graduation rate at 7½ percent, undue hardship could be engendered as a result of simultaneously increasing costs of goods and services not related to housing. Perhaps a safeguard would be to require the 10 percent downpayment for this option.

The implementation of this alternative would be fairly easily accomplished by HUD in Washington. It would simply require a notice to the HUD field offices and the mortgagees, and would call for no formal training of underwriters.

A third preventative device that may be used to guard against defaults is more frequent monitoring of loans insured under section 245 than for 203(b) or other types of loans. It is our understanding that under the present loan management procedures, a loan is considered in default after 30 days of nonpayment. At this point, the second payment is also due, making the borrower really delinquent on two payments. At some point between the due date of the payment, and before 60 days have expired, the mortgagee is to make an attempt to arrange a personal meeting with the mortgagor—except in certain circumstances. This does not apply if the mortgagor (a) doesn't reside on the property, (b) is 200 or more miles from the mortgagee, or (c) doesn't elect to attend such a meeting.

At that meeting, it is hoped that an agreement would be reached to bring the loan current, and default counseling by HUD-approved counseling agencies may be recommended by the mortgagee.

Past experience has indicated that if default counseling is conducted at an early stage of delinquency, the chances for default and foreclosure are decreased considerably. However, the HUD central office does not become aware of loans in default until approximately 90 days after the due date of the payment and we recognize the hardships that would be imposed if more frequent data were submitted to them. Therefore, it is incumbent upon the mortgagee to insure that these precautionary measures take place. HUD should reinforce their directives to the mortgagees to ensure the prompt implementation of these measures.

It is our recommendation that in relation to Section 245 mortgages, the current procedures for servicing such loans be accelerated so that a call is made to the mortgagor 14 days after the first payment is due. Current procedures do not require that such a call must be made. The determination of a possible problem could be realized by the mortgagee at that time, a meeting could take place if warranted, and default counseling would, therefore, not be delayed to a great degree. We would also encourage that periodic random checks be made by HUD of the servicing being conducted by the mortgagees. As we are asking for an acceleration of servicing procedures rather than added processes to be accomplished by the mortgagee, no added servicing costs should be incurred by the mortgagees or servicers.

Senator BROOKE. I thank you for those comments and we certainly will give them consideration. I think you raised the question of whether the individual having account would be available only for purchase of a first principal residence. I want to assure you that that was my intent and that is the way it was written in the legislation. But our tax counsel has drafted the appropriate changes to section 221 (a) to clearly specify that the individual housing account applies only to the first principal residence.

Mr. HANRAHAN. We understand. Thank you, Senator.

Senator BROOKE. Then I have one further clarification you raised relative to the savings account portion of the bill. The individual housing account would operate in a similar manner to the individual retirement account. In fact, when the bill was drafted, it was patterned after the individual retirement account. The taxpayer would deduct deposits into an IHA as an adjustment to gross income rather

than an itemized deduction. Therefore, it would be available to a taxpayer who used the standard deduction in his income tax return and I wanted you to understand that position as well.

Finally, Mr. Arquilla, I hope that you will carry the message to your membership, because I'd like, frankly, to have not just the support of the homebuilders but their belief that this legislation can be helpful to the first home buyer and to the homebuilders.

Mr. ARQUILLA. Senator, perhaps you'd like to join our deliberations at our May board meeting and speak to the situation yourself.

Senator BROOKE. You're a far better advocate than I and I have a new responsibility now and my chairman keeps my feet to the fire, but I appreciate the invitation. You've got a fine man sitting to your right there. Mr. Coan has been a very strong advocate for housing.

Mr. ARQUILLA. I can assure you, Senator, that we are not taking a stand certainly against this proposal.

Senator BROOKE. I understand.

Mr. ARQUILLA. I'm sure that we did have a conversation with our executive committee about 3 weeks ago and there were no dissents to the proposal and I would not think that we would have dissents from our board, but as I say, we just don't have the policy and when it is established we will be getting back to you.

Senator BROOKE. We'll ask Mr. Coan to be my surrogate.

Mr. COAN. Senator, there's one thing I'd like to point out with respect to our commonsense proposal as the market rate level increases the amount of subsidy involved increases. It's a rather lengthy thing and it may not be apparent initially, but it's got a floor of 6 percent. Now we may never get back to a 6 percent mortgage interest rate but our hope is to get interest rates down lower than they are now and as the rates lower the interest rate with respect to each price level does decrease.

Senator BROOKE. I want to thank you and I want to take this opportunity, Mr. Chairman, if I may, to thank you for first giving us such expeditious hearings on this legislation and then for giving it your personal attention by being here during the entire first session of these hearings. I'm very grateful to you and to all of those witnesses who have testified.

The CHAIRMAN. I'm delighted. I think Senator Brooke deserves a world of credit for the initiative he's taken on this, and of course, there are two reasons why this is very important. It's an excellent initiative. There's nobody who hasn't indicated that it has merit. There's some question of the extent to which it will be effective, but others say it will be very effective.

The second reason, of course, is because Senator Brooke has developed a reputation for being a man to get things done in housing and I'd better watch him because if I don't he's going to do all kinds of things that I may find after he's got it practically accomplished which I don't like, but I think I may like this.

At any rate the committee will stand in recess until tomorrow when we hear from primarily administration witnesses. Thank you very much.

[Whereupon, at 1:05 p.m., the hearing was recessed, to be reconvened at 10 a.m., Friday, April 1, 1977.]

YOUNG FAMILIES HOUSING ACT OF 1977

FRIDAY, APRIL 1, 1977

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10 a.m., in room 5302, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire and Brooke.

The CHAIRMAN. The committee will come to order.

The first three witnesses have graciously agreed to appear together and our procedure under these circumstances as you may know is to have each of the witnesses deliver their statement and then we question after the statements have been delivered.

Incidentally, if any witness would like to abbreviate their statement in any way, shape or form, it will be printed in full in the record as Senator Brooke said, provided the abbreviation is not longer than the statement.

We just had you before us yesterday, Mrs. Shalala, and I don't know if we have acted on your nomination or not, but it certainly received the warm and enthusiastic approval of everybody I've talked to on the committee and elsewhere. We are delighted to have you this morning and go right ahead. I beg your pardon. Senator Brooke wanted to say something.

Senator BROOKE. Mr. Chairman, before we begin I must bring up a problem. As you know the committee requests that witnesses make their testimony available 48 hours in advance of their appearance. This permits the members to read their statements before the hearings and to prepare questions for the hearings. Most of the private witnesses of these hearings have complied with the committee's request. However, none of the Government witnesses, except the Congressional Budget Office, complied with the rule and in the case of HUD we didn't receive their testimony until 7:15 last night after members had left their offices.

I don't want to make a big issue of this and I realize there are always extenuating circumstances, but I do think with Government witnesses, with all the funds we appropriate for their offices, they might extend us the same courtesy that private witnesses do.

Last year we appropriated over $60 million for HUD's Policy Development and Research Office and over the years I have been the principal defender of this part of HUD's budget against attempts by the House and the chairman to make cuts. Mr. Chairman, it appears

88-114 O - 77 - 11

that the principal issue of this panel is the desirability of the cost of the proposal for an individual housing account contained in the bill that we have offered.

I also would just like to say, Dr. Shalala, I have heard wonderful things about you and we expect that you will do an excellent job when you are confirmed and have taken office.

The CHAIRMAN. I might say, in fairness, while this is the rule and we should enforce it rigorously and we will do our best in the future, frankly, we have not had statements that much in advance. We did get Dr. Woodworth's statement yesterday and it was available so we could get it last night. I didn't get Dr. Shalala's until this morning, but as I say, the 48 hour rule has been honored more in the breach other than in the observance and in the future I think Senator Brooke has a good point. In fairness, I should say you're just about par. I hope you do better.

Dr. Shalala, go ahead.

STATEMENT OF DONNA SHALALA, ASSISTANT SECRETARY-DESIGNATE FOR POLICY DEVELOPMENT AND RESEARCH, DEPARTMENT OF HUD, ACCOMPANIED BY DR. ROBERT BUCKLEY, DIVISION OF HOUSING AND FINANCIAL ANALYSIS, HUD

Dr. SHALALA. Senator, I hope we do better than par in the future and I do apologize for that statement being late. It's my fault because I just arrived in town. I told the Secretary this morning I thought it was a little unfair to send me up here to get in trouble since I had not been confirmed yet, but she said I should come ahead. Again, let me apologize for the lateness of the statement and I do not intend that it will happen again.

[Complete statement follows:]

STATEMENT

BY

Donna E. Shalala

Assistant Secretary
for
Policy Development and Research
Department of Housing and Urban Development

THANK YOU, MR. CHAIRMAN

I am happy to be able to appear before you today to discuss the Department's views on S.664 and S.1078, two proposals that are directed at the problems of young homebuyers. There is little doubt that in recent years the housing finance system in general and young non-homeowners in particular, have especially suffered the twin burdens of inflation and recession.

As this Committee well knows, high and volatile interest rates have caused the cost of homeownership to escalate and the supply of mortgage credit to dry up periodically. Each of these proposals attempts to address these problems and foster the American dream of homeownership.

Since both proposals are concerned with HUD's authority to insure graduated payment mortgage loans under the 245 program, I would like to first briefly describe our activities and plans for the program.

HUD Insurance of Graduated Payment Mortgage Loans

In an effort to ascertain the impact of alternative mortgage instruments on the mortgage market, the Department requested in 1973, and received in Section 245 of the Housing and Community Development Act of 1974, the authority to insure loans which would help meet the needs of potential homebuyers who were priced out of homeownership. Such mortgages could comprise up to 1 percent of the FHA loans insured during a fiscal year on an experimental basis.

Since the experience with alternative mortgages, and therefore the analysis devoted to them, was minimal at that time, the Department co-sponsored a major study by the Sloan School of Management of MIT, which surveyed all aspects of alternative mortgage instruments, including the foreign experience. Using the results of this study, and also consulting with a variety of mortgage lenders, the Department designed five different graduated payment instruments which would be insurable under the authority of the 1974 Act.

Graduated payment loans allow mortgagors to borrow additional money during the early years of the mortgage by reducing the monthly mortgage payment due. This additional loan is added to the mortgage and is repaid through slightly higher payments that will be made in later years.

With the 245 program, a homebuyer can choose one of five possible GPM plans, selecting the one which best suits his or her needs. The five plans vary the rate at which the monthly payments increase -- from 2 to 7½ percent per year -- and the number of years over which the payments increase -- either five or ten years. I have included for the record a table describing the different plans.

Regulations governing the 245 program were issued in November of 1976, and based upon expected insurance activity, insurance authority was allocated throughout the country. We are now insuring our first loans under the 245 authority.

<u>The Role of Graduated Payment Mortgages</u>

Both bills propose that HUD's graduated payment mortgage insurance program be expanded from its present one percent of the FHA loans insured. Inherent in such a recommendation is the view that despite the many benefits afforded by the standard level-payment, fixed-rate, long-term, mortgage instrument, it may not be the optimal home financing method for everyone. Indeed, during periods of high interest rates and inflation, it is likely that the exclusive use of the standard instrument has limited the home-buying opportunities of many, particularly young families.

Expanding the insurance authorization for graduated payment loans does not mean that we believe these instruments will replace the standard mortgage instrument. Rather, we see them as a useful complement to the traditional mortgage form. It is a complement which will allow some borrowers to better match mortgage payments to income and maintain a constant ratio of payments to income. Clearly, this instrument is unsuited to the borrower with fixed income, and we would never suggest such use for GPM. However, it should be particularly helpful for young homebuyers who currently have low incomes, realisticly optimistic income prospects, and limited ability to borrow against future (higher) income.

It is important to stress that it is not only the upwardly mobile who can benefit from a graduated payment loan. With the standard level-payment instrument, there is an inflation caused "tilt" in real mortgage costs. For example, with a three percent rate of inflation, the purchasing

power of a dollar is worth 40 percent less in 12 years. To compensate for the inflation-eroded value of the constant nominal payments of the standard mortgage instrument, lenders include a premium in their loans. Accordingly, while expected inflation does not change the real cost of long-term loan, it does redistribute these costs so that the earlier years of a loan require higher monthly payments in real terms.

Clearly, the preferred solution to this problem is to reduce the high and variable inflation rates which are the source of the cost redistribution. Indeed, since GPMs are designed to shift this tilt so that payments more closely approximate those of the standard mortgage instrument in a non-inflationary period, one would expect less demand for GPMs in a more stable economic environment.

Nevertheless, as long as there is some inflation a family does not have to have expectations of continually increasing real income to find a graduated payment loan desirable. They need only expect their nominal income to grow at the rate of inflation. And while this implies that the potential audience for graduated payment mortgage loans is larger than the number of young upwardly mobile families, it also implies what I stressed at the outset -- the graduated payment loan is not for everyone: it is a complement rather than a substitute for present financing arrangements.

In our view, the underlying rationale for the 245 program is that there are a variety of housing finance needs and the housing finance system should be able to accommodate this variety. Just as FHA helped to foster the standard mortgage instrument in the Depression, the 245 program can perform a related function in today's shifting economic environment. We are optimistic that the private mortgage insurance industry will use the actuarial information derived from the program to build a healthy private underwriting program for graduated payment mortgages, as they have done with the traditional fixed-payment fully-amortized mortgage.

I would now like to comment on how the proposed legislation relates to our objectives for this program.

1. The expansion of insurance authority and the pre-emption of state laws which pose obstacles to the use of graduated payment loans

Under the current experimental program, GPM insurance is allocated among states by FHA to provide homeownership opportunities for families in all states. Unfortunately, many states now have laws which prohibit GPMs because in the early years of the mortgage the mortgage payments are not sufficient to cover the accrued interest on the mortgage.

The spirit of the state laws is to protect consumers from various borrowing schemes which serve progressively to indebt a borrower without providing a prospect for absolving the debt. Clearly, GPMs are not a noxious debt instrument. Furthermore, they provide an explicit schedule of payments and loan terms which allow a full and complete repayment of all principal and interest.

An additional reason for exempting GPM's from the state restrictions is to provide equal homeownership opportunities in all regions of the country. To be useful in analyzing mortgage behavior the sample of GPM's should be nationwide rather than restricted to a few states.

Actually, expansion of FHA authority for GPM insurance and exampting GPMs from State interest rate restrictions are complementary features of this legislation. Unless exemption from State capital interest rate laws are provided, it is doubtful whether the volume of GPMs will grow sufficiently to allow the GPM to truly be an alternative mortgage instrument.

2. Changing the 245 Program Down Payment Requirements

S.664 modifies the existing down payment requirement in several ways. The current requirment under Section 245 is the same as under section 203(b); that is, the principal outstanding can not exceed 97% of the first $25,000 in value plus 90% of the additional value from $25,000 to $35,000 plus 80% of the additional value above $35,000 and less than $45,000.

The initial minimum down payment for a graduated payment mortgage is larger than implied by these figures due to the negative amortization in the early years of a loan and the limits on the principal outstanding. The maximum loan to value ratio on a $20,000 house, for example, ranges between 94% and 97%, depending on the type of GPM chosen. On a more expensive home, the current maximum is much lower, with the maximum loan to value ratio ranging between 88% and 91% for a $45,000 home.

The bill proposes to include the 97% maximum loan to value ratio in Section 245 of the National Housing Act, thereby duplicating the limit as specified in Section 203(b)(2). The bill would further limit the initial loan to value ratio to 90% on graduated payment mortgages only. This change would severely discriminate against families with low-income and little wealth, a category into which many young potential homebuyers fall.

As the previously mentioned figures indicate, this would require virtually no change in the existing GPM plans for homebuyers in the range above $40,000, but would double the required down payment for low-priced homes. These homes are primerily starter homes for persons of moderate means. These families are less likely to have capital gains from the sale

of previously owned homes, and are therefore the least likely to be able to bear the additional down payment burden. The families most adversely affected by this change are those for which homeownership is just outside their reach, and they may well be falling farther behind due to the rising price of houses. It is just this group that the bill is intended to reach.

The intent of the increase in the initial downpayment to 10% is to reduce the risk of the loan. This is a laudable objective, but unfortunately this change will have a marginal effect on FHA default experience since the outstanding principal balance limit is not changed. Default for the most part depends on the rate equity accumulates relative to the debt outstanding. The current 245 regulations permit borrowers to increase their outstanding debt by about 3 percent over the life of the loan. Changing only the initial down payment, as S.644 suggests could allow outstanding debt to increase by about 7 percent more than the original principal balance. We do not believe that this will make the loans less risky. Conversely if the present rates of graduation are maintained with the higher downpayment requirements, the principal outstanding balance will not exceed 93% of the maximum loan to value ratio. We believe that aiding first time homebuyers, the ones most affected by this change, is worth the increased risk. Moreover, insuring under Section 245 is a small part of total FHA activity. The 97% maximum loan to value ratio and 3% minimum downpayment would still apply to level payment loans insured under Section 203(b).

This is not an effective way to address the problem of FHA default risk exposure, and it places an excessive burden on households of modest means, the intended beneficiaries of the bill.

The Individual Housing Account

As I understand it, this portion of S.664 is subject to further amendment and revisions. Accordingly, I would like to defer a final comment on the specifics of this complex legislation until a final draft is prepared. However, I would like to stress to the Committee that while the Department of Housing and Urban Development is very interested in the downpayment problems faced by first time homebuyers and by the limited savings options available to small savers, we have serious misgivings about both the regressiveness of the subsidy, and the high level of tax expenditures associated with it. A rough estimate of the tax loss generated by an IHA program that is restricted to first time homebuyers, places it on a level equal to current tax expenditures for the deduction of mortgage interest for all homeowners - $5 to $6 billion. Even more conservative estimates indicate that a $3 to $4 billion per year range is reasonable. In addition, the complications experienced in writing this legislation point to the potentially serious tax administration problems.

In conclusion, I would again like to commend the authors of these proposals for their concern with the problems of young homebuyers. Their proposals are innovative, have addressed complex technical issues, and have generated interesting public discussion of pressing issues.

I would be pleased to answer any of the Committee's questions.

Attachment A

Types of Graduated Payment Loans Available through the 245 Programs

Rate of Graduation	Term of Graduation
2-½ percent	5 years
5 percent	5 years
7-½ percent	5 years
2 percent	10 years
3 percent	10 years

The CHAIRMAN. Thank you very much, Dr. Shalala.

Dr. Woodworth, I think this is the first time that you have appeared in your present capacity before this committee and we certainly welcome you with open arms. You have earned a reputation in the Congress as being, some people feel, the premier staff man of them all. We have consulted you so often on the floor to get your advice on pending tax legislation. Those of us who aren't on the Ways and Means Committee or the Senate Finance Committee have learned that your advice has been very sound and extremely helpful. So we welcome you. We are delighted to have you. Go right ahead, sir.

STATEMENT OF LAURENCE N. WOODWORTH, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, ACCOMPANIED BY EUGENE STEUERLE

Dr. WOODWORTH. Thank you very much, Senator Proxmire.

[Complete statement follows:]

STATEMENT OF THE HONORABLE LAURENCE N. WOODWORTH
ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
ON INDIVIDUAL HOUSING ACCOUNTS BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
APRIL 1, 1977, 10:00 A.M.

Mr. Chairman and members of this distinguished Committee:

It is an honor to make this appearance before you today to testify on the proposed Amendments to the National Housing Act. My testimony will be directed to the specific provisions which grant tax relief for the establishment of individual housing accounts (IHA).

Before proceeding to the proposal itself, I would like to examine briefly the problem to which I believe this proposal is directed. Real estate and housing prices have climbed markedly over the last two decades. There are, of course, significant existing tax incentives for homeownership. In fact, these incentives undoubtedly contributed to the rise in the fraction of occupied dwelling units which are owner-occupied -- from 55 percent in 1950 to about 65 percent in 1974. Nonetheless, many households -- in particular newly formed families -- do not have adequate savings to make the initial down payments to purchase houses or condominiums. Since financial institutions need insurance or protection for the loans that they make, the absence of a sizeable down-payment excludes some potential homeowners from the market for homes.

In general, there are two ways in which government can intervene to help the potential homeowner. The first is to provide adequate insurance to mortgage lenders so that the amount of down-payment required to purchase a house is lowered. For instance, if a savings and loan association needs protection of $10,000 over and above a lien on the house, government provided insurance or guarantees of $7,000 would reduce the required down payment from the potential homeowner to $3,000. Essentially, this is the procedure for loans sponsored by the Veterans Administration.

The second means of aiding the potential homeowner is to provide him with direct cash assistance, either through grants or through tax reductions. In this case, to solve

the down payment problem, the value of the grant or the tax reduction must equal the difference between the required down payment and the savings of the potential homeowner. For a down payment of $10,000 (or protection of $10,000 to the lending institution), a $1,000 or $2 000 tax reduction or grant still leaves the potential homeowner with required savings of $8,000 or $9,000 to purchase the house. In general, the amount of tax relief or grant must equal the size of the loan guarantee in order for a potential homeowner to make up the difference between the protection amount required by the financial institution and taxpayer's own savings. In terms of revenue loss then, tax reductions and grants are probably far more expensive than are government guarantees of loans, even if there are significant defaults on guaranteed loans.

The provision for individual housing accounts contained in S. 664 falls into the latter category of government intervention -- assistance through tax reductions or grants. Whatever its other merits, the revenue cost of tax or grant assistance is quite high. For instance, we estimate that the cost of the bill (as we understand it will be amended) will be $6 billion for the first year, and $5 billion annually after a few years. This estimate assumes that when fully effective there would be 12 million total accounts and about 2 million new accounts per year.

As provided in the bill, contributions to individual housing accounts would be deductible up to $2,500 a year and up to $10,000 for all taxable years. We are given to understand further that the bill will be amended so that a family may establish only one individual housing account for the purchase of its first principal residence. Interest on funds in this account would also be exempted from taxation. Distributions from the account must be made within ten years of its creation and if those distributions are for purposes other than the purchase of a principal residence a ten percent tax penalty would be applied to the amount of the distribution. The Treasury s concerns with the proposed legislation fall into several categories -- equity effects, effects on saving and the demand for housing, problems with the penalty provisions, and other technical considerations.

Equity Effects

The tax savings generated by an individual housing account (IHA) increase with a taxpayer's marginal tax rate. For example, assume that $1,000 is deposited in an IHA that yields a 6 percent rate of return and assume that this deposit is kept in the account for 5 years before withdrawal.

The tax savings is zero for the non-taxpayer, $327 for a taxpayer in the 20 percent marginal tax bracket and $758 for a taxpayer in the 50 percent bracket. The example illustrates the perverse equity effects of the proposal, particularly in light of the objective of providing a subsidy to those least able to afford to purchase a home. In short, the greatest tax savings accrue to high income taxpayers who are most able to save for a home and who already receive substantial tax benefits for homeownership.

Tax Savings for a $1,000 Investment
In an Individual Housing Account

Marginal Tax Rate	Tax Savings	Tax Savings as a Percent of Value of Account*
0 %	$ 0	0.0 %
15	248	18.5
20	327	24.4
30	478	35.7
50	758	56.7

* At withdrawal after 5 years, the account would be worth $1,338.

Effects on Savings and the Demand for Housing

It is unlikely that the proposal would increase savings by very much and in the short-run it may decrease the demand for housing. Since debts and monies are fungible, it would be impossible to ascertain whether an individual's savings put into an IHA actually increased his savings or merely shifted the form of his savings. For instance, those who already have adequate savings to provide a down payment for a house may switch current savings into an IHA to take maximum advantage of the tax deduction.

For many other taxpayers, it would be advantageous to borrow the amount of money that is put into the IHA. The interest earned on the IHA could totally offset the interest paid on the borrowed funds, leaving the taxpayer equally well-off in before-tax income However, the interest on the loan and the deposit in the IHA would be deducted from taxable income leaving the taxpayer much better off in after-tax income even though his net savings would be zero.

Thus, it is clear that it is not necessary to increase savings at all to gain the tax advantage of the IHA. Any increase in the demand for housing is also likely to be modest relative to the revenue cost. For instance, consider an average family in the 20 percent tax bracket needing $10,000 for a down payment on a $40 000 home. The bill could easily reduce required savings for the down payment by about 25 percent However the tax benefit as a percentage of the purchase price of the house would amount to only about only 6 percent. Thus, in the short run the taxpayer must still come up with 75 percent of the down payment, while in the long run he must come up with 94 percent of the cost of the home.

Moreover the demand for housing may initially decrease upon passage of this bill. Families with adequate current savings for a house may decide that it is worth delaying their purchase of a house until they have taken all the tax deductions allowed by the proposal For instance, as indicated in a previous example a taxpayer in the 30 percent marginal tax rate bracket could gain tax savings of $478 merely by switching $1 000 of savings into an individual housing account and leaving it there for 5 years Thus, a taxpayer would be given a strong tax inducement to delay the purchase of a house until all the tax benefits of an IHA have been received Under the plan presented in this bill, tax benefits to the holder of an individual housing account would last up to 10 years.

Penalties for Withdrawal

Another disturbing aspect of the plan is the penalty to those who may need to withdraw savings from an IHA for some purpose other than housing. Individuals' needs change over time in an unpredictable way -- even with respect to housing -- and the tax laws should not lock them into fixed commitments. Families with changes in housing or other demands caused by death, divorce, unemployment, sickness, etc. should not be penalized because they need to spend their savings or because

they have less need for housing. The government should not be in the business of determining which changes in demands are allowed and which are not. It could be argued that the penalty for withdrawal of funds for taxpayers other than housing is set at the low rate of 10 percent for just this purpose.

On the other hand, for many taxpayers, the 10 percent penalty for withdrawals other than for the purchase of residences would not prevent the use of these accounts as tax shelters For example, upon retirement, a taxpayer who had previously realized tax savings for depositing $1,000 in an IHA could easily make up for the tax penalty as long as he moved into lower tax rate brackets at the time of withdrawal. It is even possible for some taxpayers to realize tax savings after paying the penalty even without a reduction in tax rates.

Unfortunately, there is no way to allow flexibility in the use of funds without creating an incentive for abusing the provisions. Certainly, no simple penalty can recapture all the tax advantages received by those who do not purchase a house while allowing some relief to those whose plans have changed due to unforseen circumstances.

Comparison with Individual Retirement Accounts

I realize that the individual housing account proposal is modeled, at least in part, after the individual retirement account. However there are two crucial differences between these accounts. First the individual retirement account (and the Keogh Plan) is a limited program designed to achieve tax equity between taxpayers not covered under employer pension plans and those who are so covered. Individual housing accounts, on the other hand, would be made available to a larger segment of the population and would create inequity -- not only because of the distribution of benefits by income class but also because they would provide yet another advantage to homeowners which is not available to renters.

Secondly, while an individual retirement account cannot be withdrawn before retirement years, funds in the account when withdrawn can be used for any purpose the taxpayer desires. Individual housing accounts, on the other hand, not only require withdrawal within a certain number of years, but penalize the taxpayer if his anticipated need for housing has been replaced by a need for medical care, food, clothing or any other good.

Thus, while individual retirement accounts and individual housing accounts have certain features in common, the retirement accounts are designed to correct a rather specific tax inequity, and they allow more flexibility in the final distribution of the funds.

Other Considerations

I think it is also important to emphasize that this proposal moves away from the trend toward simplification of our tax laws. If the bill were adopted, the number of deductions would increase and a new tax form would be required. Moreover, the bill implicitly requires lifetime recordkeeping by the taxpayer and/or the Internal Revenue Service to insure that no taxpayer can take advantage of more than one housing account over his lifetime. Finally elaborate rules would be needed to deal with family reorganizations through marriage, death, and divorce For instance what tax treatment would be accorded a taxpayer who remarried someone with a house, yet who held an individual housing account with his or her former spouse?

Finally, there are technical features of the bill that are unattractive First, the bill grants tax savings to a taxpayer who deposits funds into an individual housing account one day and withdraws them the next day to provide a down payment on a house Second, since current law allows for exemption of certain capital gains on housing sold by taxpayers aged 65 or older the change in basis required under the proposal would not be adequate to insure that the income originally put into the IHA would eventually become reportable for tax purposes. That is, a taxpayer could save in an IHA, reduce the basis value of his house by the amount of the IHA that went into the down payment, and, upon selling of the house, be allowed an exemption for capital gains which resulted from the excess of sales price over the reduced basis. For some income put into the IHA, then, the deduction is permanent and not recaptured later. Even if recaptured, the ordinary income deduction would be taxed at capital gains rates. I realize that these features might be corrected, but, again, at the cost of additional complexity in our tax laws.

Conclusion

Let me summarize the Treasury Department's position on this bill. While we are sympathetic to the concerns to which this bill is addressed, we do not believe that tax

reductions or grants are appropriate mechanisms to generate funds for down payments on houses. Individual housing accounts are extremely expensive relative to the benefits they provide. Beyond this, on equity grounds, individual housing accounts would grant benefits to individuals who already have substantial tax incentives for investment in housing and who need not increase their savings in order to realize the benefits of the proposed legislation. On efficiency grounds, the accounts would grant numerous tax benefits to many individuals without increasing their supply of savings or demand for housing. Finally, on simplicity grounds, these accounts would increase the complexity of both tax reporting and tax administration.

The CHAIRMAN. Thank you very much, Dr. Woodworth, for a remarkable statement.

Dr. Kaplan, you have an extremely long statement, 58 pages and an appendix. What can you do in 10 minutes?

Dr. KAPLAN. I have a short summary, Senator.

The CHAIRMAN. How long is the short summary?

Dr. KAPLAN. Ten minutes exactly.

The CHAIRMAN. All right. The full statement will be printed in full in the record.

STATEMENT OF DONALD M. KAPLAN, CHIEF ECONOMIST AND DIRECTOR, OFFICE OF ECONOMIC RESEARCH, FEDERAL HOME LOAN BANK BOARD

Dr. KAPLAN. Thank you. I appreciate the opportunity to present testimony this morning on behalf of the Federal Home Loan Bank Board on S. 664, the Young Families Housing Act.

As I'm sure you've noticed, my testimony is quite lengthy and thus what I'd like to do is summarize the major points so as to leave as much time as possible to respond to your questions.

My full statement is organized into three major sections. First, we have attempted to develop a broad conceptual review of the downpayment question, including the degree to which the downpayment is in fact an obstacle to home ownership and what the real facts are with regard to present downpayment requirements and practices. In this regard, I find I must disagree with several of the conclusions drawn by my good friend, Dr. Kenneth Rosen, in his testimony before this committee yesterday morning. Also, in the downpayment part of the testimony we discuss evidence on the relationship between downpayments and foreclosure risks and the prospects for future reductions in downpayment requirements given the inherent tradeoff in the relationship between downpayments and monthly payments.

In the second major section of the statement we provide a rather extensive analysis of the GPM and how various different versions of GPM's compare regarding their impact on homeownership affordability, both among themselves and relative to the standard fixed payment mortgage. Of particular interest here are some brand new analyses we have come up with regarding the potential market for GPM's and other alternative mortgage instruments as well. If you're interested, we can go through some of these figures later.

The other major point in our discussion of GPM's is an analysis of income eligibility requirements for GPM borrowers.

The third major section of the statement reviews several concerns we have relating to the individual housing account which I will come back to in a moment.

However, before turning to a few key specific points in each of the major areas, I should mention that we have also attempted to indicate how specific elements of our ongoing alternative mortgage instruments research study is already helping us to understand the GPM and other types of alternative instruments. I would be glad to elaborate on any of the specific studies if you wish. Also, I have attached

as a technical appendix a copy of a very preliminary and as yet uncompleted working draft chapter on GPM's and deferred interest mortgages being developed as part of our study.

Let me now mention some of the key observations. First, with regard to downpayments, there is an inherent tradeoff between downpayments and monthly payments in all types of mortgage instruments, the implications of which must be fully understood to properly assess the GPM and the individual housing account proposals. Thus, as downpayments are reduced, loan amounts must increase, and similarly the monthly payment must increase. Second, the inability to meet downpayment requirements is not nearly the obstacle to homeownership affordability as is the inability to meet monthly payments. This is a very key point.

Third, in fact, downpayments as a percentage of appraised property values are quite low by historical standards, and thus the prospects for further significant lowering of downpayment requirements are not good.

In this regard, yesterday Ken Rosen spoke of the high level of the current average downpayment requirements of approximately $11,000 and how he was forecasting it and housing prices as well to double in the next 10 years, with downpayments moving into the $20,000 to $25,000 range and average home prices to around $90,000. I find these statistics somewhat misleading in that when you focus in carefully on the first time home buyer you find the typical downpayment is in the range of $2,000 to $4,000 as opposed to $11,000. This wide divergence in our respective estimates comes from a failure to separate out home purchases by existing homeowners from those by first time purchasers, conventional mortgage statistics from FHA and VA figures, and the use of average versus median statistics, to mention but a few.

As for the $90,000 estimated house price in 10 years, I must also disagree. Simplistic linear extrapolations are an old and familiar pitfall. Ken assumed house prices will continue to inflate faster than all other prices, but that personal incomes will continue to inflate more slowly than all other prices. This is clearly—and Ken identified it as such—a worst case assumption.

Now, 2 days ago the AP wire service carried a story about a study done by an economist in one of the colleges in Virginia. Based on the 1975 inflation rate, he calculated the average priced home would increase from approximately $45,000 today to $258,000 in the year 2001. That's the kind of calculation that will get you a loaf of bread costing $30.

Now, of course, house prices will rise, but so will income, and our behavior will change as well. Just as we are about to discover that we must now change our automobile and energy related preferences and behavior, so we may have to learn to live in houses with smaller rooms, no fireplaces, fewer bedrooms, carports instead of two car garages, et cetera. Also, we may have to spend a somewhat larger share of our income on housing in proportion nationally and less on vacations, entertainment and other discretionary items. An affordability gap, certainly; a problem, of course; but a crisis with housing prices doubling overnight, I seriously doubt it.

With regard to the graduated payment mortgages which we favor, first, the downpayment-monthly payment tradeoff problem holds for graduated payment mortgages just as it does for all other types of mortgage loans.

Second, if the GPM is really to achieve a lowering of borrowers' income eligibility requirements, we must recognize that such lower monthly payments necessarily require a higher downpayment, unless you build in a government subsidy or unless you gamble on inflation and property price appreciation to bail you out down the road a few years.

We praise S. 664 for resisting the temptation to go that route.

Third, in fact, the income eligibility requirements are significantly lower with the GPM, 28 percent lower in the case analyzed in our statement, but I must caution that GPM's are not for everyone, just as reverse annuity mortgages and variable rate mortgages are not for everyone. If a borrower's income is not anticipated to increase regularly over the next 5 or 10 years, he or she should not be given a GPM.

Fourth: And on a more technical point, I do not believe it is clear yet how fast the FHA insured Brooke-type GPM will find a home in the conventional mortgage market. Although Ken Rosen spoke of two PMI companies ready to write private mortgage insurance on GPM's, we have as yet no default experience on GPM's and thus we do not know what the cost and associated monthly payment impact of PMI coverage will be on such loans.

Fifth: I do agree with Ken that the potential market for GPM's is substantial, as some of our tables from our study work indicates.

Sixth: And my last point on GPM's is that we believe that a 10-percent downpayment requirement is unnecessarily restrictive and should be eliminated. This would give HUD maximum flexibility in designing an array of GPM's which vary in graduation rates and downpayments.

Now let me turn to the individual housing account. Unfortunately, we are not favorably inclined toward the IHA proposal as it stands. We believe that its benefits are likely to be minimal for low- and moderate-income people and for middle-income people as well. Moreover, we think that whatever the benefits, they are certainly to be outweighed by the tax revenue losses to the Federal Govrnment. If the IHA proposal should be adopted, we would encourage the following modifications:

First: We recommend that a tax credit arrangement be substituted for the proposed tax deduction approach. This would eliminate the regressiveness of the plan whereby disproportionate benefits would accrue to higher income individuals.

Second: We recommend that a lower limit on the size of the allowed deduction for——

The Chairman. Mr. Kaplan, I'm going to have to go to the floor to vote. Senator Brooke is going to stay here as long as he can and then he will have to go over to the floor and vote and I will come back and we will have to carry on. But complete your statement and Senator Brooke will question you. I will be right back.

Dr. KAPLAN. Second: We recommend that a lower limit on the size of the allowed deduction or, preferably, the credit be adopted. Specifically, we recommend that the maximum annual tax credit be set at $500, which would be equal to one-third of a maximum cash contribution of $1,500 per year.

Similarly, we recommend that a maximum $2,500 lifetime tax credit equal to one-third of up to $7,500 cash contribution be established. The reason for this recommendation is that, realistically, the average family could not begin to take full advantage of the proposed tax benefits for substantial cash contributions.

For example, today with the median family income at approximately $14,000 and with the average savings rate at around 7 percent, the average family saves approximately $1,000. These savings are used for emergencies, vacations and a host of other things. It is simply not realistic in our view to assume that a tax benefit will be able to induce a threefold additional savings behavior from middle-income families. However, upper income households could easily reroute $2,500 of savings each year to take advantage of the proposal.

Third and finally: As the bill is worded, we do not see any reference to a requirement that the IHA be used for only a first-time home purchase. Without such a restriction, tax benefits would flow to second- or third-time home purchasers and the cost to the Federal Government would be very large.

Senator, this concludes my comments. Thank you for the opportunity to appear.

[Complete statement follows:]

STATEMENT OF

DONALD M. KAPLAN
Chief Economist and Director
Office of Economic Research
Federal Home Loan Bank Board

I appreciate the opportunity to testify on behalf of the Federal Home Loan Bank Board (the "Board") on S. 664, The Young Families' Housing Act. As you know, many of the issues raised by this Act are being studied in-depth in our Alternative Mortgage Instruments Research Study (AMIRS). This is a study that we are quite proud of at the Board since it is examining all of the major issues involved with respect to various new types of mortgage instruments, some of which are already available while others are still in the proposal stage. Thus, we are developing factual and analytical material pertinent to new mortgage instrument proposals coming from Congress, where each such proposal has an important bearing on the extent to which we can deal with the housing affordability issue. Attached to this testimony is a technical appendix that is a preliminary draft of an analysis that has been made of certain alternative mortgage instruments as part of AMIRS.

The Young Families' Housing Act makes a valuable contribution to the dialogue currently going on with respect to the housing affordability issue by putting forth proposals that attempt to deal with both the downpayment and monthly payment costs of home-ownership. Specifically, the Act contains two major provisions. The first would replace the present <u>experimental</u> graduated payment mortgage (GPM) program by a <u>permanent</u> program. The GPM permits an upward tilt in the monthly payment schedule that makes it particularly suitable for young families who cannot meet the intial

monthly payment required under a standard fixed payment mortgage but whose future income prospects are such that they expect to be able to make increasingly larger monthly payments as a result of rising income. We are favorably inclined toward a permanent FHA-insured GPM program but, as the testimony indicates without a restrictive minimum 10 percent downpayment requirement. We hope that this will be a precursor to the offering of conventional GPMs, with or without private insurance, by lenders.

The second part of the bill, which carries an additional title, the Individual Housing Account Act, would set up a tax-sheltered "individual housing account" (IHA) that would provide substantial tax benefits to those accumulating funds for a down-payment on a principal residence. To the extent that this makes it possible for individuals or families to put down a higher down-payment on a house, it will make it possible for monthly payments on the mortgage--whether a standard fixed payment mortgage or a GPM--to be lower than would otherwise be the case. We believe that the benefits of the proposal are minimal for low and middle-income households and are outweighed by the tax revenue losses for the Federal Government.

Thus, the Act addresses both the downpayment and monthly payment problems of homeownership. However, there is a trade-off problem between a downpayment and the monthly payments under

any type of mortgage instrument, and this trade-off needs to be clearly understood. There is also the need to recognize default risks created by programs that reduce downpayments and/or ease the initial monthly payments through creating an upward tilt in the monthly payment schedule, since such risks have a bearing on the feasibility of new mortgage instrument proposals such as the GPM.

In the following discussion the conclusions that come through are that downpayment requirements still remain low historically and that there is probably little that we can do to reduce downpayments significantly from present amounts expressed as a percentage of property values. This holds in the context of either the standard fixed payment mortgage or the GPM. In the discussion below, I discuss, first, the degree to which the downpayment is an obstacle to homeownership and what are the facts with regard to present downpayment requirements and practices. Second, I examine the evidence on the relationship between the downpayment and mortgage foreclosure risk. Third, I discuss the future prospects for a decline in downpayments given the trade-off between downpayments and monthly payments. Finally, I discuss the downpayment problem under the GPM as distinct from the standard fixed payment mortgage. This provides a lead into our critique of GPMs and how various

types of GPMs compare in their impact on homeownership affordability both among themselves and relative to that of the standard fixed payment mortgage.

Downpayment Problem and Options

As you know, anyone who desires to buy a house must both meet a downpayment requirement and also demonstrate a financial ability to meet a continuing flow of monthly payments over the life of the mortgage. It so happens that some individuals and families that could meet the monthly payments on a mortgage loan of the appropriate amount do not yet have an adequate downpayment and are faced with the need of raising funds for such a downpayment. This is particularly true of younger individuals and families. There are a variety of ways in which individuals or families accumulate an adequate downpayment. In some cases, they receive gifts from their parents. In the case of newlyweds, it is common for the income earned by one spouse to be used solely or primarily to build up the downpayment. The purchase of a house is typically deferred until such time as an adequate downpayment has been built up from the income of the spouses. Alternatively, the home purchase may be deferred until the first or perhaps the second child is born or on its way. In many cases, part or all of the downpayment may be met by a second mortgage or by borrowing part or all of the downpayment through some other means.

Our knowledge of the sources of funds for downpayments should be enhanced by a national survey of consumers that will be undertaken with the objective of both assessing the sources of downpayment funds and ascertaining consumer attitudes and perceptions toward downpayments. This study is being funded by the Bank Board as part of AMIRS. It is to be conducted by the Joint Center for Urban Studies of MIT and Harvard University and has the broader objective of increasing our understanding of the role of downpayments in the housing and mortgage decision-making process of consumers. The survey is ready to be implemented, awaiting only final clearance from OMB.

In recent times, the need to build up a cash downpayment has not been an insurmountable problem for the average American family since downpayment requirements have come down considerably over past decades. While most families have always had to delay their purchase of a home in order to accumulate a downpayment, this has not been a major obstacle to homeownership. The fact is that almost two-thirds of American households do own their own home presently and, in the middle age range, the home ownership rate exceeds 75 percent. This is quite impressive when we consider the large range of income distribution and the fact that so many individuals and families earn incomes considerably below the national norm.

The present heightened concern with the downpayment problem stems from the fact that the rise in the median price of homes has outstripped the rise in family income in recent years. Given no dramatic change in percentage downpayment requirements generally since the early 1970s, the result is that the burden of accumulating an appropriate downpayment has increased relative to family income. However, the phenomenon of downpayments rising at a more rapid rate than family income is still only a recent phenomenon. Over a long period of time, from 1955 to 1975, the average downpayment on new homes has risen less than family income in percentage terms. Whether the present more rapid rise in downpayment relative to family income is part of a new trend is, of course, a matter of conjecture and depends on future trends in home prices and downpayment requirements.

It needs to be emphasized that interpreting aggregate data on average downpayments for either new or existing homes can be very difficult. This is because downpayments vary considerably for the same house price because of differences in practices by various lenders and differences among geographical regions. The data from the Board's survey on terms on conventional home mortgages indicates that, of new homes financed by conventional mortgages in 1976, 11 percent involve a downpayment of under 10 percent and

21 percent involve a downpayment of under 20 percent down to 10 percent. Another 41 percent involve a downpayment of under 30 percent down to 20 percent. In the case of conventional mortgages on existing homes, the average downpayment was only 2 percentage points higher than in the case of new homes. For existing homes, five percent involved a downpayment of under 10 percent while 18 percent involved a downpayment of under 20 percent down to 10 percent, and 47 percent involved a downpayment of under 30 percent down to 20 percent.

These figures illustrate the wide diversity of downpayments on conventional mortgages. However, they are still not altogether pertinent as to what downpayments are paid by the young first-time home purchaser. This is because most mortgages made in a given year are to households buying a second or third home. Such households are in a position to make a higher downpayment than the minimum required by the lender because of the large equity received from the sale of their current home. Thus, it is reasonable to assume that young first-time home purchasers typically make lower downpayments than indicated by the data above derived from the universe of all mortgage borrowers.

As you may know, the Board permits Federal savings and loan associations to require a downpayment as low as 5 percent for conventional mortgages up to $42,000 if there is private mortgage insurance or if the association builds up appropriate reserves against such mortgages. The availability of such low downpayment mortgages varies considerably among lenders and regions. Typically, the low downpayment mortgage is more commonly available on new than existing homes, as the earlier figures indicate. It appears that builders who construct townhouses or detached homes designed for the first-time home buyer are more likely to attempt to arrange with lenders commitments for conventional mortgages that involve downpayments as low as 5 percent. Low downpayments, however, are not costless. Because of their greater default risk, they result in a higher interest rate, which of course increases the monthly payments. In addition, the cost of private mortgage insurance is passed on to the borrower, usually in the form of higher monthly payments.

In the case of Federally underwritten mortgages the downpayments can even be less than on conventional mortgages. The downpayment can generally be as low as 3 percent of the appraised value for a mortgage insured under FHA Section 203(b) if the appraised value does not exceed $25,000. The downpayment requirements increase, however, as the appraised value increases above

this level. The downpayment is 10 percent on the amount of the appraised value of the property between $25,000 and $35,000 and 20 percent of the appraised value above $35,000. In 1975 the average downpayment for new homes insured by FHA was 7.2 percent and for existing homes 5.1 percent. These are much lower than the average figures noted above for conventional mortgages. Low down-payment FHA-insured mortgages are not costless, however, since they involve a 1/2 of 1 percent insurance fee, which adds to monthly payments, although part of this fee may be refunded since FHA insurance is based on a mutual insurance fund. In the case of the unsubsidized Section 203(b) FHA insurance program, involving only standard fixed payment mortgages, losses have been covered by this insurance fee.

While the use of FHA insurance makes possible a lower down-payment, the use of the standard FHA mortgage has declined sharply over time. There are a multiplicity of reasons that may explain this: (1) the maximum $45,000 mortgage amount permitted under FHA, (2) the fact that the downpayment requirement becomes progressively greater as the mortgage exceeds $25,000 in amount, which is not an adequate mortgage amount in high cost areas, (3) the fact that many lenders prefer to make conventional mortgages with as low as 5 percent downpayment relying on private mortgage

88-114 O - 77 - 13

insurance, and (4) the processing time and delays that are encountered by lending institutions that utilize FHA. In this regard, it should be noted that processing delays can be eliminated through the use of a relatively new FHA co-insurance program, but this program has not yet proved popular with lenders. Also, the Secretary of HUD has recently proposed an increase in the FHA mortgage maximum that would have the practical effect of making low downpayment loans under FHA more generally available.

Even more liberal downpayment provisions are available for those who are eligible for VA guaranteed home loans. VA financing can be obtained with no downpayment, often for mortgage amounts in excess of the limit set under the FHA insurance program. In 1975 the average downpayment on new homes financed by VA mortgages was 4.0 percent and, for existing homes, was 2.9 percent. Thus, VA provides a means for an even lower downpayment--in most instances no downpayment at all--than does FHA. Unlike FHA, there is no insurance fee paid by the VA borrower. Losses on VA mortgages are absorbed by the Federal Government.

Data available from the Census Bureau throw interesting light on the median downpayment as a percent of sales price for all new homes sold by builder, no matter how financed. In 1975, the median downpayment was 10.2 percent for all new homes sold. This

means that half of the buyers made a downpayment of under 10.2 percent and the other half over 10.2 percent. Given that a large proportion of these homes are purchased by households that already own a home with a significant equity in it, this median downpayment appears quite low. This data may appear at variance with the Bank Board's own data on mortgage terms. However, the Board's data excludes FHA and VA mortgages, on which downpayments are quite low. The Board's data also includes conventional mortgages on houses not on the sales market but built to order for (only) the owner. Conventional mortgages on such custom-built homes, which account for a fairly large percentage of total single-family starts, typically involve a higher downpayment than homes being sold by builders.

It also needs to be emphasized that the national statistics on downpayments obscure significant differences among regions. Thus, the present $45,000 limitation on FHA mortgages and the increasing downpayment requirement after the first $25,000 tends to make this program most attractive for regions of the country where home prices are lowest. In contrast, FHA provides much less opportunity for minimizing the downpayment relative to that available on conventional mortgages in those regions with high house prices. If Congress should vote an increase in the maximum mortgage amount on FHA mortgages, this would reduce to some extent

the inter-regional differences with respect to the availability of low downpayments on FHA mortgages.

This analysis of downpayment requirements and experience indicates that low downpayments are reasonably widely available to many first-time home purchasers, particularly in the case of new homes. Potentially, they would be even more available for purchasers of both new and existing homes if the FHA maximum mortgage limitation was raised with higher property values subject to the minimum 3 percent downpayment requirement. However, for this to have truly widespread impact, it would require greater lender willingness to utilize FHA, perhaps through an attempt to promote more aggressively the FHA co-insurance program.

With respect to conventional mortgage loans, the downpayment requirement is a function of lender willingness as well as regulatory restrictions. Normally, lender willingness to make minimum low downpayment loans is greatest during periods of easy housing credit, such as exists at the present time. Low downpayment loans are available on many new housing developments in a large number of metropolitan areas, particularly on those aimed at first-time purchasers who are young families.

Relationship of Low Downpayments to Risk

In assessing the feasibility of further decreases in downpayments, it is useful to review studies on the role of downpayments in mortgage delinquencies and foreclosures. These give varying degress of weight to downpayments (i.e., the converse of the loan-to-value ratio) as a factor affecting delinquencies and foreclosures. The Housing and Home Finance Agency (predecessor of HUD) conducted a special survey of mortgage foreclosures on single-family homes in six metropolitan areas in the 1961-62 period, including FHA, VA and conventional mortgages. It was generally observed that loan-to-value ratios as well as term-to-maturity, age of loan, and housing expense-to-income ratios were all related to mortgage foreclosure. A Federal Housing Administration study observed several noteworthy relationships in a 1962 analysis of foreclosures. The age of the loan appeared to be the most important factor but with borrower characteristics considerably more important than property and loan characteristics in determining foreclosure.

A comprehensive study by John Herzog and James Earley using 1963 survey data analyzed the post-World War II changes in the quality of home loans. The Herzog-Earley study found the presence

of refinancing and junior financing to be the most important variables, but loan-to-value ratios were also significant as determinants of foreclosure risk.

Several studies by George von Furstenberg have assessed the determinants of mortgage risk. In two studies using FHA and VA data, von Furstenburg observed that the loan-to-value ratio (hence, the downpayment) was the most significant determinant of mortgage risk, with term to maturity and age of mortgage also significant. In a third study, von Furstenberg also found the loan-to-value ratio to be the single most important determinant of mortgage risk.

A localized study, using a set of observations of loans in Connecticut obtained in 1973, was conducted by T. Gregory Morton. He found the variables "5 or more dependents," junior financing, high loan-to-value ratios and the existence of non-real estate debt all to be positively associated with higher delinquency and foreclosure rates.

The studies above are not completely conclusive as to the exact relationship between the size of the downpayment to foreclosure risk. Overall, however, it appears that past research

studies have found that the size of the downpayment is a significant factor in explaining mortgage default experience. As regards alternative mortgage instruments, including GPMs, our AMIRS study includes a special analysis of likely default experience. While not yet complete, the preliminary evidence suggests that expected default experience on GPMs is likely to be higher than on standard fixed payment mortgages. I will comment on the implications of such a higher default expectation for GPMs later in this testimony.

Prospects for Downpayments in Future

There appears to be a ready explanation as to why average or median downpayments have not declined significantly in recent years. The same reasons also suggest why we should probably not expect much assistance to housing affordability in the future from decreases in downpayments. The reasons, which follow from our discussion above, are (1) that downpayments currently are already low in a long-term historical context, (2) that reductions in downpayments beyond a certain point would increase the lender risk (or that to FHA or private mortgage insurance companies) to a degree that is unacceptable, and, finally, (3) there would be an adverse impact of still lower downpayments on monthly payments arising from the trade-off problem that I discuss below.

Further declines in downpayments are still possible to a limited extent and might well be helpful to certain individuals and families who are capable of handling higher monthly payments. However, the rapid increase in both new and existing home prices in recent years and the even more rapid rise in the operating costs of homes has shifted the problem facing individuals and families to an increasing degree from that of accumulating an adequate downpayment to that of meeting the income requirements necessary to meet monthly mortgage payments and operating costs. Thus, attempts on the part of mortgage borrowers to utilize still lower downpayment loans would merely exacerbate the monthly payment problem and reduce the ability to meet monthly housing costs. This is only in small part because of the higher interest rate or the insurance fee required on such low downpayment loans. Primarily, it is because, with lower downpayments, a higher mortgage amount must be amortized over the life of a lower downpayment mortgage, and this results in higher monthly payments.

During much of the post-World War II period, the adverse impact of lower downpayments on monthly payments was offset by increases in the maturity of mortgage loans. However, with the average maturity of conventional mortgages made in 1976 about 26 years and even greater for federally-underwritten mortgages, there

is little room left for using longer maturities as a means of dealing with the trade-off problem between downpayments and monthly payments. In fact, it can be shown that stretching the maturity of a mortgage loan beyond thirty years does not contribute significantly to lowering the monthly payment since reductions in payments on mortgage principal that result from this are largely offset by increased interest payments on the larger average mortgage balance.

Graduated Payment Mortgages and Their Potential Market

Traditionally, the trade-off problem between downpayments and monthly payments has been analyzed only for the standard fixed payment mortgage. For this type of mortgage, we have probably gone almost as far as possible in terms of making downpayments lower without raising monthly payments and pricing households out of the housing market because of inability of incomes to qualify for monthly payments. Thus, while the availability of low downpayment mortgages should be a continuing goal of housing policy, we should not look to this to be a significant means of improving the affordability of housing for most first-time home purchasers under the standard fixed payment mortgage. What is necessary are new, alternative mortgage instruments that can

retain a reasonably low downpayment and yet deal with the monthly payment problem at the same time. The GPM may be a good example of this and we shall analyze the degree to which GPMs can meet these conflicting goals.

As indicated earlier, the Young Families' Housing Act would authorize a permanent FHA-insured GPM program in lieu of the present experimental 245 program. The use of the GPM permits lower monthly payments in early years than is possible under the standard fixed payment mortgage but requires higher monthly payments in later years. The use of the GPM allows the building in of a "tilt" into the monthly payment schedule that makes homeownership more affordable in the sense that it reduces income eligibility requirements for meeting monthly payments because of the lower monthly payments during the early years of the mortgage.

This mortgage is especially well designed for the young individual or family who has reasonable prospects of a rising income stream over time. For such households, the graduated payment mortgage enhances the ability to meet the income eligibility requirements of homes at the time of purchase without resulting in a significant increase in monthly payments relative to income in the later years of the mortgage. Given the design and the

objective of the GPM, it is very important to understand that there are likely a very significant number of households who would benefit by the availability of GPMs. We know this from another of our AMIRS research study projects currently underway.

This project involves a study of the socio-economic characteristics of the U. S. population for the purpose of being able to determine the extent to which various population subgroups would appear to have a demand for various alternative mortgage instruments, based on their wealth and income status over time. The sample and data permit the estimation of the wealth and income status of the approximately 41.1 million families and unrelated individuals that were renters in the U. S. in 1968. More recent data and a more elaborate analysis are currently being investigated.

Table 1 presents the data. It shows the number of households that rent, according to the amount of financial assets, the level of income, and the average annual increase of income. The amount of financial assets indicates the downpayment capacity of these households. The level of income indicates the current mortgage carrying capacity. The average annual increase in income indicates the ability to make rising mortgage payments as with a GPM.

Table 1. Estimates of the Number of Families and Unrelated Individuals Renting in the U.S. in 1968, According to the Amount of Financial Assets, Income Level, and Increase in Income (Thousands)

Financial Assets, 1968 (dollars)	Level of Income, 1968	Average Annual Increase in Income, 1968-75: Less Than $300	Between $300 and $1,000	Over $1,000
zero	Less than $3,500	2,077	1,264	3,379
	$3,500 to $7,000	934	466	100
	Over $7,000	67	18	0
$0 to $1,000	Less than $3,500	0	17	482
	$3,500 to $7,000	98	46	121
	Over $7,000	81	36	36
$1,000 to $2,000	Less than $3,500	0	20	1,118
	$3,500 to $7,000	157	505	141
	Over $7,000	362	153	75
$2,000 to $3,000	Less than $3,500	0	4	1,438
	$3,500 to $7,000	187	382	426
	Over $7,000	351	406	148
$3,000 to $5,000	Less than $3,500	0	25	2,287
	$3,500 to $7,000	273	655	803
	Over $7,000	874	721	744
$5,000 to $10,000	Less than $3,500	4	0	4,400
	$3,500 to $7,000	164	219	973
	Over $7,000	1,568	1,878	2,705
Over $10,000	Less than $3,500	0	0	2,811
	$3,500 to $7,000	62	54	158
	Over $7,000	1,135	839	2,656

Sources and Notes: The data were supplied by Professor Jim Smith, Penn State University, on leave at Yale University, as part of his "Demographics Study" for the Alternative Mortgage Instruments Research Study The primary data come from the Panel Study of Income Dynamics for 1968-197 The Panel Study consists of a national sample of over 5,000 families being conducted by the Survey Research Center University of Michigan, Ann Arbor, Michigan Financial assets consists mainly of cash, checking and savings accounts and stocks and bonds as estimated based on a number of socio-economic characteristics of households The methodology for estimating the amount of financial assets is explained in Guy Orcutt, Steven Caldwell, and Richard Wertheimer, Policy and Experimentation Through Micro Analytic Simulation, Urban Institute, Washington, D.C., 1976, and is based on wealth data in the 1962 Survey of Financial Characteristics of Consumers, Board of Governors of the Federal Reserve System.

Income is measured as "take-home pay," net of taxes. The level of income and its average annual increase are the intercept (in 1968) and the slope, respectively, of the regression of income on time for the 2,711 families in the sample who were originally renters.

However, what would be most relevant to willingness to use a GPM would be <u>expected</u> increases in income. The increases in income, when they occurred, may or may not have been expected. It is when such increases are expected that GPMs would be most in demand, because the households then can expect to meet the rising payments under GPMs. It may be that many households whose income did not rise had in fact expected such a rise but were disappointed. Thus, data on <u>actual</u> income increases does not tell us as much about demand for GPMs as would <u>expected</u> income increases, although the actual increases do tell us about those households that might have been able to afford rising payments.

The inflation rate averaged about 6 percent per year over the 1968-1975 time period, so that these data must be viewed with this in mind, since the income increases are in nominal terms. Also, such events as an increased family size could have accompanied any increases in income, so that the mortgage carrying capacity could have been reduced. Attempts are being made to refine the data in the hope of being able to account for these other events. This will involve examining data such as shown in table 1 according to age, family size, race, occupation, etc. An analysis according to age, for example, may indicate more

accurately those families that have rising income <u>expectations</u> and thus might find GPMs attractive mortgage instruments.

With the problems of inference aside, the data in the table do tell us that there are many families with rising incomes. These households may have been able to meet the rising payments of GPMs. Figure 1 illustrates the types of distinctions made in table 1. Families are classified, first, by liquid wealth status. Then, for each class of wealth, they are classified according to the 1968 level of income, and, finally, by the increases in income over the period 1968-1975. As shown in the figure, a family with a $2,500 income in 1968 is classified as to whether it had no increase (or a decrease) in income over the next eight years (line A), whether it had annual increases of $300 to $1,000 (line B), or whether it had increases of over $1,000 (line C). Obviously, the last case is the most important in terms of the ability of the family to meet the rising payments. The family is classified, in each wealth category, as to whether it had a higher initial income level, and as to the possible income trajectory over the next eight years (lines A, B, C starting from a 1968 income level of $9,000). In this case families with income trajectories B or C may have found the GPM attractive and useful in being able to purchase a home.

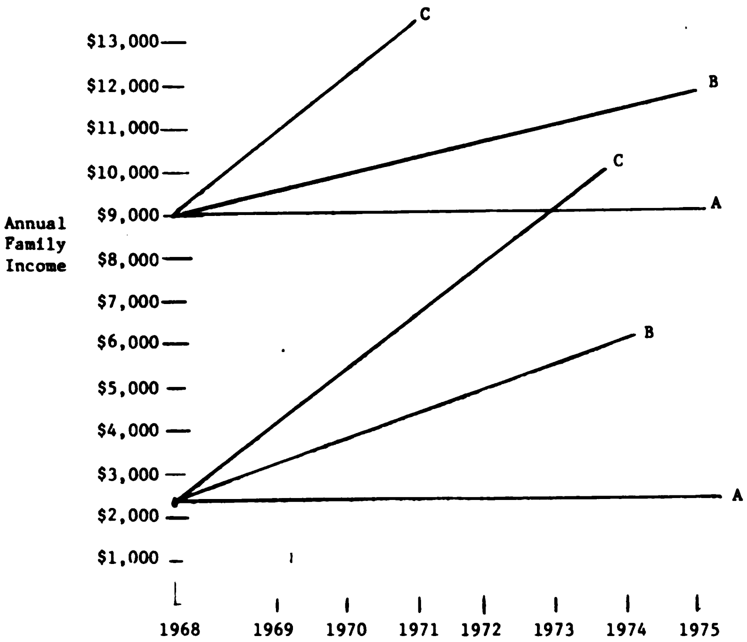


Figure 1. Alternative Income Trajectories, 1968-1975.

Families with high wealth, with low current income, and with high income increases may have found the GPM very useful. As shown in the lower right-hand corner of table 1, 2.8 million families were estimated to have had over $10,000 in financial assets and less than $3,500 in income in 1968, but with annual increases in income of over $1,000. At the other extreme, those with low wealth accumulations but high income growth might also have benefitted from GPMs (as well as from downpayment assistance). The upper right-hand corner of the table shows that an estimate of 3.4 million families had no financial assets and less than $3,500 in income in 1968, yet had, on average, annual increases over the next eight years of over $1,000. While the last column may be the most pertinent from the standpoint of the attractiveness of GPMs, many of the families in the middle column, whose incomes increased by $300 to $1,000 annually, may also have found a GPM useful. The primary data reveals that all the families in the last column had annual increases of over 10 percent as did all those in the second column with initial 1968 income less than $7,000. All these families might have found a GPM useful. The rest of the families in the second column and those at the top of the first column had incomes increasing between 5 and 10 percent, and a low graduation GPM may have been useful. On the basis of 1976 estimates, of 55.1 million renters, 70 percent could

expect to have annual increases in income over 10 percent if the 1968-75 experience could be extrapolated while 15 percent could expect annual income increases of 5 to 10 percent.

Thus, even with this very preliminary aggregative data, we can see that there is very likely a large demand for GPMs. At least many families who were non-owners appear to have been able to afford the rising payments. In addition to the renters examined in the analysis above, homeowners are being as well. Many of these may have preferred a GPM instead of the standard fixed payment mortgage. With a GPM they may have been able to afford the amount of house that more nearly matched their income expectations. We believe that the full data to be generated in this study will be very helpful in defining the potential demand for GPMs as well as other mortgage instruments.

Relationship of GPM to Downpayments

What about the relationship of the GPM to downpayment requirements? The GPM can clearly enhance affordability in terms of initial monthly payment requirements. However, its ability to contribute to lower downpayments is constrained to the extent

88-114 O - 77 - 14

that we insist that the stream of future monthly payments be such that there is always some positive equity in the house based on a market valuation of the house that equals the appraised value at time of purchase. One could, of course, take it for granted that GPMs would be underwritten only on houses that would have a significant appreciation potential. If so, one could design an FHA-insured GPM that had at least as low as a downpayment as that on an FHA-insured standard fixed payment mortgage. The negative amortization in the early years of the GPM would eliminate the equity in the house based on the appraised value at time of purchase. But, presumably, this elimination of equity would be more than offset by a positive impact on equity due to the rise in house prices.

Our feeling, however, is that relying on rising home prices to maintain a positive equity would be a risky proposition. Not all houses appreciate in value or appreciate to the same degree. Moreover, there might well be little or no appreciation in early years even though appreciation over the long-run is highly likely, and the result could well be a negative equity in the house in the early years of homeownership. Moreover, as I testified last August, we would have serious concerns regarding the possible "redlining" implications of any new mortgage instrument that

requires a substantial property price appreciation in order for repayment to be feasible. Thus, we are pleased that the Young Families' Housing Act accepts the need to devise a monthly payment schedule that would not take for granted increases in the value of the house.

For this reason, this Act would permit the offering of various GPMs subject to the restriction that generally the outstanding principal balance of an insured GPM may not at any time exceed 97 percent of the appraised value of the property covered by the mortgage determined as of the date the mortgage is accepted for insurance. This requirement does permit a smaller equity for properties over $25,000 in value than the formula being used for the experimental 245 program, which is identical to that for the FHA-insured standard fixed payment mortgage. But it still retains the principle that any price appreciation in the house cannot be taken for granted in designing the monthly payment schedule.

However, the GPMs authorized under The Young Families' Housing Act would have a downpayment requirement of 10 percent, which is greater than that for FHA-insured mortgages of the standard fixed payment form. This higher downpayment requirement appears to be based on a supposition that a GPM with a significant upward "tilt" is necessary in order to permit a substantial

lowering in the income eligibility of households based on the initial monthly payments. A significant "tilt" prevents permitting downpayments as low as that on FHA-insured standard fixed payment mortgages although it is not clear to us why there is need for a minimum downpayment as high as 10 percent.

The specific reason why there are certain limits (although not necessarily the 10 percent specified in the Act) as to how far one can reduce the downpayment on a GPM with a significant tilt is that the stream of monthly payments with such a tilt implies negative amortization for a significant number of years. Not only is there no payment on the principal of the mortgage in the early years, but the payment is less than would be required to cover the interest due on the mortgage. Thus, there is essentially a deferral of some of the interest that produces negative amortization and reduces the amount of equity in the house relative to the initial purchase price. This reduces the equity below the downpayment.*

---

* A brief comment on still another of the AMIRS projects--the legal analysis--is appropriate here. A long list of pertinent legal, regulatory and legislative issues are being currently evaluated. For example, of particular relevance here is the preliminary conclusion that negative amortization will be viewed as "interest on interest" which is currently prohibited in over 30 States. If this assessment is correct, GPMs may only be feasible contingent on Federal legislation which would over-ride individual States' prohibition on negative amortization.

If the downpayment is made too low on a GPM, there is little scope for much upward tilt in the payment schedule since this would rapidly eliminate the equity in the house altogether, based on the initial value of the house. Thus, insofar as we desire a significant tilt in the payment schedule, we must have a downpayment that is above that presently required for the standard fixed payment mortgage under the FHA 203(b) insurance program. Nonetheless, while we understand the need for adequate downpayments on GPMs, we would recommend that any permanent GPM program not specify any particular minimum downpayment in the statute that is more stringent than for standard fixed payment mortgages, but permit flexibility to HUD to design alternative GPMs, some of which could combine a modest upward tilt and lower than 10 percent downpayment.

Alternative Types of GPMs

It is possible to design a large number of variations on the GPM theme. These would include the so-called standard GPM that has a constant tilt or graduation rate over the life of the mortgage, as well as the modified GPM, used in the experimental 245 program, where the graduation rate applies to, say, the first 5 or 10 years and is then followed by constant monthly payments

payments over the remaining life of the mortgage. A third type of GPM would involve deferring payment on part of the contract interest rate for a specified number of years, such as five years. Again, our AMIRS study is examining all of these variants of the GPM.* We would be reluctant to state at this point in time precisely which variants of the GPM may be most feasible. However, our present feeling is that the modified GPM is probably the most feasible type since the standard GPM with any significant tilt has very little or negative equity over most of its life, based on the intial property value, and the deferred interest GPM results in an undesirable large escalation in monthly payments at the end of the five year period that is probably not feasible in the absence of a Government subsidy. This is recognized in the experimental section 245 program, which involves modified GPMs with level payments after 5 or 10 years.

In order to understand the possible implications of the proposed permanent GPM program, it is useful to review briefly the five current experimental GPM plans. Table 2 shows the

----

* The technical appendix attached to this testimony is in fact a very preliminary internal working draft of a portion of our AMIRS analysis of the economics of GPMs.

Table 2. HUD Section 245 Graduated Payment Mortgage Plans for a $40,000, 30-Year, 8.5 Percent Mortgage

GPM Plan			Comparison to an 8.5% Standard Mortgage				
Graduation Rate	Years of Graduation	First-Year Payments	Reduction in First-Year Payments		Year in Which GPM Payments Become Larger	Eventual Annual Increase in GPM Payments vs. SFPM Payments	
			Dollars	Percentage Reduction		Dollars	Percentage Increase
2.5%	5 years	$3356	$335	9%	5	$106	3%
5.0	5 years	3053	638	18%	5	206	5%
7.5	5 years	2780	911	25%	5	300	8%
2.0	10 years	3258	433	12%	8	281	7%
3.0	10 years	3058	633	17%	8	418	11%

modified GPM plans, which differ according to the rate of graduation of annual payments for 5 or 10 years. For a $40,000, 30-year, 8.5 percent interest rate GPM, the initial annual payments for the first year are shown in the table. These annual payments are compared to those on a 30-year, 8.5 percent standard fixed payment mortgage. The experimental modified GPMs reduce initial monthly and annual payments by 9 to 25 percent compared to those of the standard fixed payment mortgage, depending on the plan. However, as the table indicates, the payments eventually become higher. The modified GPM plan that produces the largest increase in payments relative to that on the standard fixed payment mortgage is the 3 percent, 10 year graduation GPM. Payments at the end of 10 years are 11 percent greater than that of a standard fixed payment mortgage of the same interest rate. The GPM payments remain lower than those under the standard fixed payment mortgage for the first seven years of the 10 year plans and for the first four years of the five year plans. Subsequently, the GPM payments exceed those under the standard fixed payment mortgage.

Analysis of the Permanent GPM Proposal

The Young Families' Housing Act would have an impact on the type of GPMs that could be as offered as compared to that under the current experimental GPM program. This is because

the experimental GPM program is subject to the same downpayment requirements as that applicable to FHA-insured standard fixed payment mortgages under Section 203(b). This would also control the minimum ratio of the borrower's equity to the original appraised value over the life of the mortgage, which would rise increasingly over 3 percent for appraised properties above $25,000. In contrast, the GPMs authorized under the Young Families' Housing Act, referred to here as the "Brooke" GPMs, would be in some respects more restrictive and in other respects more lenient than conditions imposed upon the experimental GPMs. Thus, the Brooke GPMs would be required to have a downpayment no less than 10 percent of the appraised value of the property but then would permit the ratio of the borrower's equity to the original appraised property value to be as low as 3 percent at some future point of time even for appraised property values above $25,000. Both the experimental and Brooke GPMs would be subject to the maximum mortgage amount for single family residences, which is currently $45,000 but for which legislation is pending to raise this amount. Both GPMs are also subject to the FHA underwriting standard that total housing costs cannot be greater than 35 percent of after-tax income.

As I noted in an earlier part of the testimony, the minimum downpayment required for the FHA standard fixed payment mortgage is based on a sliding scale, with the downpayment only 3 percent for the first $25,000 of appraised property value. The experimental GPMs that are currently offered with FHA insurance have the same statutory downpayment requirements as those that apply to the FHA-insured standard fixed payment mortgage. However, in practice this leads to higher downpayments since the actual downpayment for the experimental GPMs has to take account of the fact that these mortgages have negative amortization which reduce the borrower's equity in the house--expressed as the difference between the original appraised value of the house and the outstanding mortgage balance. The ratio of this equity to the original appraised value of the property can never fall below the minimum downpayment requirement for the FHA standard fixed payment mortgage. Given negative amortization in early years, this means that the experimental GPMs must start out with a downpayment that is sufficiently above that on a standard fixed payment mortgage so that the negative amortization does not reduce the ratio of the equity to the original appraised property value below the minimum downpayment requirement.

The experimental GPM plan with the most negative amortization and with the most dramatic initial effects is the one that has payments increasing by 7.5 percent annually for five years with constant payments for the remaining 25 years. We have examined this plan, both as it exists in the present experimental program and as it would have to be modified under the different conditions that pertain to a Brooke GPM. We trace through the implications both as between these two GPMs and a standard fixed payment mortgage that would be possible on a property of the same appraised value. Table 3 summarizes the comparisons among these three types of mortgages as well as with what might be termed a modified Brooke GPM, which would permit a three percent downpayment or equity requirement irregardless of the property value but without the minimum 10 percent downpayment requirement that is presently contained in the Young Families' Housing Act.

The first set of comparison shown in table 3 is for the highest house price that can be purchased under the assumption of the lowest possible downpayment and constrained by the maximum $45,000 mortgage amount that present law permits. The downpayment on the experimental GPM for the maximum house price possible under FHA maximum mortgage limitations is 12.7 percent (i.e. an 87.3 percent initial loan-to-value ratio). This is above the

Table 3. Comparisons of FHA Section 203 Mortgages, Experimental Section 245 GPMs, and Brooke FHA GPMs Using the Minimum Required Downpayment

	FHA 203	Experimental 245 GPM	Brooke Proposed FHA GPM	Alternative GPM Without 10% Downpayment Requirement
Maximum Value of the House	$49,688	$47,898	$48,199	$46,392
Minimum Downpayment	$ 4,688	$ 4,519	$ 4,820	$ 3,013
Loan Amount	$45,000	$43,379	$43,379	$43,379
Effective L/V Ratio	90.6%	87.3%	90%	93.5%
Minimum Annual Income	$16,608	$12,058	$12,058	$12,058
For A $45,000 House:				
Minimum Downpayment	$ 3,750	$ 5,236	$ 4,500	$ 2,923
Loan Amount	$41,250	$39,764	$40,500	$42,077
Effective L/V Ratio	92%	88%	90%	93.5%
Minimum Annual Income	$15,224	$11,053	$ 9,381	$11,696
For a $35,000 House:				
Minimum Downpayment	$ 1,750	$ 2,950	$ 3,500	$ 2,273
Loan Amount	$33,250	$32,052	$31,500	$32,727
Effective L/V Ratio	95%	91.5%	90%	93.5%
Minimum Annual Income	$12,272	$ 8,909	$ 7,297	$ 9,097
For a $25,000 House:				
Minimum Downpayment	$ 750	$ 1,624	$ 2,500	$ 1,624
Loan Amount	$24,250	$23,376	$22,500	$23,376
Effective L/V Ratio	97%	93.5%	90%	93.5%
Minimum Annual Income	$ 8,950	$ 6,498	$ 5,212	$ 6,498

Notes: Applies to single-family houses over a year old or houses before construction. For houses less than a year old or under construction, the downpayment requirement is higher. The downpayment requirement for veterans is lower. All mortgages are 8.5 percent for 30 years. The GPM for both the Experimental 245 and the Brooke propoeal is the "steepest" GPM in the HUD Experimental 245 program: payments increase at 7.5 percent annually for 5 years. This GPM has the lowest initial payment and the most negative amortization.

The "Minimum Annual Income" (after tax) is obtained from the FHA underwriting standard that "housing costs" be at most 35 percent of annual after-tax income, which is applied to the first-year payment and income for the GPMs; and the assumption that 25 percent of the required 35 percent constitutes principal and interest.

9.4 percent downpayment on the standard fixed payment mortgage. However, the Brooke GPM would permit a downpayment--10 percent--almost as low as that on the standard fixed payment mortgage. The modified Brooke GPM would permit the lowest downpayment of all--6.5 percent. The maximum value of the house and of the mortgage loan possible would be greatest under the standard fixed payment mortgage but the amounts would not be reduced appreciably below those of the various types of GPMs in the table, although it would be least for the modified Brooke GPM.

The most important difference between the standard fixed payment mortgage and the various GPMs is in the minimum annual after-tax income that is required to purchase the house. For illustrative purposes only, it is assumed that the FHA income standard can be roughly translated into a requirement that monthly mortgage payments be no greater than 25 percent of monthly income at the time that the mortgage is made. Since the GPMs have lower initial monthly payments than the standard fixed payment mortgage, they imply lower income requirements. As shown in table 3, the required income for the maximum price house with a minimum downpayment is only $12,058 for the various GPMs compared to $16,608 for the standard fixed payment mortgage. This means that the GPMs reduce income requirements by 28 percent from that required under the standard fixed payment mortgage.

The Young Families' Housing Act could be interpreted as implying that GPMs whose payments are more graduated than those of any of the five GPMs in the experimental program be offered in a permanent program. This is because the higher downpayment requirement of the Brooke GPM does make more graduated payment schedules feasible without producing an intolerable negative amortization that could eliminate or almost eliminate the borrower's equity in the house as based on the initial appraised value. The Brooke GPMs can be structured to start out with a 10 percent equity, as a result of this downpayment, with the Brooke GPMs graduated so that the equity falls to 3 percent of the original value of the house before beginning to increase. For a ten year graduation period, this implies a growth in monthly payments of about 5 percent per year. For a five year graduation period, this implies a growth rate of about 13 percent per year, depending upon the interest rate. While these maximum growth rates may be high, lower ones are possible and desirable for households with a certain level of assets and certain types of income prospects. Thus, while a minimum 10 percent downpayment might become common for FHA-insured GPMs, it would be more flexible and useful to permit lenders and borrowers a greater choice of combinations of downpayment and graduated growth rates, instead of limiting the choice by requiring a minimum 10 percent downpayment. In the

It needs to be emphasized that the above numerical results are very much dependent upon the present $45,000 maximum mortgage amount and the sliding schedule on the basis of which the minimum downpayment rises for appraised property amounts above $25,000. In addition, the income requirements for the GPMs are relatively more favorable compared to that of the standard fixed payment mortgage because of the fact that our illustration is based on a GPM plan with a graduated 7.5 percent rate during the first 5 years. The difference in income requirements would be smaller for less steeply graduated GPMs.

Inclusion of the modified Brooke GPM in our analysis should not be taken to imply that we advocate that most GPMs should be issued with a downpayment below 10 percent. We would merely suggest that, in some instances, a Brooke GPM with a downpayment of less than 10 percent might be useful for types of households with certain wealth and income characteristics. In addition, since the proposed increase in the maximum mortgage amount for FHA mortgages would also result in lower downpayments for most standard fixed payment mortgages, it is only logical that the Brooke GPM not be overly restrictive with respect to the downpayment.

The Young Families' Housing Act could be interpreted as implying that GPMs whose payments are more graduated than those of any of the five GPMs in the experimental program be offered in a permanent program. This is because the higher downpayment requirement of the Brooke GPM does make more graduated payment schedules feasible without producing an intolerable negative amortization that could eliminate or almost eliminate the borrower's equity in the house as based on the initial appraised value. The Brooke GPMs can be structured to start out with a 10 percent equity, as a result of this downpayment, with the Brooke GPMs graduated so that the equity falls to 3 percent of the original value of the house before beginning to increase. For a ten year graduation period, this implies a growth in monthly payments of about 5 percent per year. For a five year graduation period, this implies a growth rate of about 13 percent per year, depending upon the interest rate. While these maximum growth rates may be high, lower ones are possible and desirable for households with a certain level of assets and certain types of income prospects. Thus, while a minimum 10 percent downpayment might become common for FHA-insured GPMs, it would be more flexible and useful to permit lenders and borrowers a greater choice of combinations of downpayment and graduated growth rates, instead of limiting the choice by requiring a minimum 10 percent downpayment. In the

experimental GPM program, only 5 plans have been offered, but a permanent GPM program could conceivably expand the number of such plans.

Implication of GPM for Income Eligibility Requirements

An important note of caution is necessary in evaluating the precise implications of a permanent FHA-insured GPM program on income eligibility requirements and the resulting increased number of households that might therefore be able to qualify for a mortgage loan. The reason is that any computations at this time are predicated on the current insurance premium of 1/2 of 1 percent of the outstanding balance. However, while this insurance premium has proven adequate under the FHA section 203 (b) program, involving unsubsidized standard fixed payment home mortgages, it may or may not be adequate for GPMs. To the extent that we envision FHA-insured GPMs as an unsubsidized program, a foreclosure and loss experience under this program significantly higher than for the standard fixed payment mortgage would require a higher insurance premium to be paid by the borrower. This, in turn, would raise monthly payments and reduce to some extent the favorable impact of GPMs on the number of households qualifying for home mortgages.

88-114 O - 77 - 15

Indeed the very fact that this program is currently being offered only under Federal insurance reflects the lack of data on the default and loss experience of this relatively new mortgage instrument. Until some experience is gained, it is possible that GPMs may not be acceptable to lenders without some form of insurance. Also private mortgage insurance companies may be reluctant to insure GPMs until adequate foreclosure and loss experience is available and certainly reluctant to do so without relatively strict underwriting standards. Thus, a Federally insured GPM program is essential at this time because (1) without it, GPMs might not be generally offered by lenders, at least not on a wide scale, and (2) there will otherwise be no way to develop a data base of foreclosure and loss experience for GPMs that could help private mortgage insurance companies determine an actuarially sound insurance premium, which would in turn facilitate offering GPMs as conventional mortgages.

In this regard it is understood in the private mortgage insurance industry that defaults on standard fixed payment mortgages usually occur with the highest frequency during the first five years of the mortgage. GPMs might well have a greater foreclosure rate in later years when monthly payments go up. But even in early years the GPM is likely to be viewed as a higher risk

than the standard fixed payment mortgage because, during the early years, the GPM has negative amortization, which impacts on equity and compounds the risk potential. Part of the difficulty in evaluating likely loss experience under GPMs at the present time is that we do not yet know what underwriting standards are necessary to make it reasonably certain that a GPM borrower is, in fact, going to have the necessary rising income stream to meet the rising monthly payments of the GPM. One possibility is that GPM underwriting standards could be made exceptionally strict in order to ensure a very high probability that GPM-qualifying households will, in fact, have an appropriately rising income. However, this almost certainly would restrict the program to a very small group and reduce substantially its potential as a means of increasing housing affordability. Moreover, any loss experience on GPMs derived from an experimental group where the underwriting standards are unnecessarily strict will not have applicability to the likely loss experience for a larger group of households at some future date.

As noted earlier, we still do not know to what extent increases in the prices of existing homes will occur during the early years of ownership and offset the negative amortization of a GPM in its early years. Even though evidence indicates that the average home will appreciate in value over a long period, there

is, as noted, a considerable dispersion in the degree and timing of appreciation among various homes, and some may even depreciate in value. Then, too, as noted earlier in this testimony, lenders may desire to restrict the underwriting of GPMs to selected neighborhoods in order to keep the loss experience within acceptable bounds. This might well lead to charges of redlining with respect to GPMs, but it is difficult to see how this type of mortgage can be successful if underwriting standards are not made somewhat more stringent--although hopefully not substantially more stringent--than for the standard fixed payment mortgage.

As noted earlier, in AMIRS we are studying the risk implications of GPMs with specific attention to the question of negative amortization. In AMIRS we are also studying the question of consumer-oriented safeguards or protections. The list of potential safeguards under review is a long one and, to a large extent, is a function of the specific alternative mortgage instrument under consideration. In the case of GPMs, examples would include limiting variations in the payment-income ratio by restricting the graduation rate and time period, limiting the default risk through a minimum downpayment requirement or maximum negative amortization, and numerous others.

It should also be noted that there may exist State and/or Federal statutory and regulatory impediments to the implementation of GPMs and other proposed mortgage forms. Consequently, one major section of AMIRS will consist of a comprehensive legal analysis of alternative mortgage instruments with the objective of distinguishing legal issues which appear unique to alternative proposed alternative mortgage forms relative to traditional mortgage forms. This section will also include an analysis of how various consumer safeguards, studied in another section of AMIRS, might be implemented most effectively.

Any discussion of the GPM should note that in February 1974 the Bank Board permitted Federal S&Ls to issue so-called "flexible payment mortgages." This mortgage is a two step type of GPM, but with no negative amortization permitted. Hence, it has only a slight tilt. During the first year after this mortgage instrument was allowed, only a few S&Ls had issued it. During the past year, more of these mortgages have been issued, and an increasing number of S&Ls are showing an interest in them. This type of mortgage instrument can be viewed as a transition to the GPM with a significant tilt that implies negative amortization in the early years.

Flexible payment mortgages will undoubtedly make it easier for S&Ls to become acclimated to GPMs that have a significant tilt. As part of AMIRS, we are collecting statistical evidence on the volume of such mortgages made in the last three years. However, because of the lack of negative amortization in flexible payment mortgages, the experience with this type of mortgage will be of only limited benefit in attempting to establish private mortgage insurance premiums for the types of GPMs currently being offered under the HUD experimental program and being proposed in this Act.

In still another section of AMIRS the Federal Home Loan Mortgage Corporation is conducting a survey of mortgage lenders that actively trade in the secondary mortgage market. In general, lenders thought that the level of risk with the GPM would be greater than that on a standard fixed payment mortgage. Hence, we can expect that a GPM would be priced at a discount in the secondary mortgage market from a standard fixed payment mortgage. This conclusion, however, presupposes no Federal insurance nor any private mortgage insurance on the use of conventional GPMs.

Since GPMs provide a lower cash flow in early years than standard fixed payment mortgages, it would appear that lenders

would require a somewhat higher effective interest rate on GPMs, even of the FHA type. This would raise monthly payments by the borrower somewhat. As a result of this reasoning, Fanny Mae has recently issued guidelines on the pricing of the experimental HUD GPMs for purchases in its GPM secondary market program. These guidelines set the pricing of GPMs at a 10 to 30 basis point discount from comparable standard fixed payment mortgages, depending on the exact experimental GPM plan. Since these GPMs are insured, the reason for the discount is based strictly on the cash flow characteristics of the GPM.

From a longer point of view, FHA insurance by itself may be an inadequate vehicle to produce a broad interest in the use of GPMs. As we indicated earlier, this is because thrift institutions and many other lenders have been reluctant to originate FHA insured mortgages because of administrative expenses in dealing with FHA both for origination and foreclosure. In addition, processing delays by FHA as well as a maximum mortgage limitation have also been factors in deterring lenders from using the FHA route on standard fixed payment mortgages. This indicates that it is probably important, if the GPM is to have an important future, to develop meaningful loss experience on GPMs under Federal insurance and hope that this will induce lenders to offer

them without FHA insurance and induce private mortgage insurance companies to be willing to offer appropriate and reasonable insurance premiums for GPMs issued on a conventional basis.

Individual Housing Account

The second provision of the Young Families' Housing Act would permit a new type of tax exempt account--an individual housing account (IHA)--whose purpose would be to permit individuals and families to accumulate equity for the downpayment on a house. This section of the bill remains essentially the same as that proposed last year with one exception. This is a provision to recapture a portion of the taxes foregone by reducing the cost basis of the house at the time of sale by the amount of the downpayment which derives from the individual housing account.

This provision could be viewed as a companion proposal of the permanent GPM program insofar as the latter has a minimum 10 percent downpayment requirement. However, this provision would clearly apply to a much broader range of households than those using an FHA-insured GPM. Hence, it must be judged on its own merits.

In the past the Board has not taken a favorable position on proposals that would permit tax deductions or credits for those who accumulate savings accounts. In general, the Board's feeling has been that such general types of tax deductions or credits applied to all savings accounts would create a substantial tax windfall for those who would have saved the money anyway. The tax revenue lost through such proposals would be quite substantial relative to any new savings or mortgage credit that would be generated.

The proposal in the "Young Families' Housing Act" to permit a tax-sheltered IHA raises, unfortunately, many of the same objections. It would permit both a deduction up to a maximum amount from taxable income for the accumulation of funds in an IHA for the purpose of making a downpayment on a primary residence and, at the same time, completely tax shelter the interest or other yield on funds in the IHA.

Eligible Assets for Housing Account

Despite the reference in Senator Brooke's introductory comments to the IHA as constituting a new type of savings account, nothing in the bill requires that it be a savings account. The

IHA would be a trust administered by an appropriate trustee. The only restrictions on the types of investments that we can find in the bill are that they not be life insurance accounts and not be commingled with other property except in a common trust fund or common investment fund. Investments in stocks or long-term bonds that can fluctuate significantly in value would apparently not be ruled out although they may well be imprudent if the funds in the IHA are to be applied to a downpayment for a house within only 3 or 4 years of the opening of the account. To the extent also that the IHA is not invested in savings accounts, they are not likely to add to the supply of mortgage credit. We are not clear whether the IHA is supposed to have this latter objective in addition to making it easier to accumulate a downpayment.

Impact of Tax Benefits on Different Income Groups

The major problem with the IHA, however, is that it provides relatively less of the tax benefits to lower and middle-income individuals and families. Moreover, the tax shelter aspects of this account do not automatically make it possible for individuals and households to accumulate a downpayment for a home. If an individual or family is so financially strapped that it cannot save money, the bill would be of no benefit since the tax benefits only

accrue to those who are able to contribute funds to the IHA. The bill would, of course, provide some incentive for even less affluent individuals or families to pare their current expenditures--to the extent that their income position permits this--in order to take advantage of the tax benefits of the IHA. However, since the tax benefit is in the form of a deduction from income, the exact amount of the tax benefit depends upon the marginal tax bracket of the individual or family. If the tax bracket is relatively low, the tax benefits are minimal.

In addition, it is probably unrealistic to expect the average young family to be able to take full advantage of the maximum deductions permitted by the proposal. Median family income for 1976 is estimated at $14,500, and it is less, of course, for the young family. It is unrealistic to expect most families with even the median income to be able to take anywhere near full advantage of the $2,500 maximum annual deduction permitted for the IHA (and to take advantage of the $10,000 lifetime deduction over a reasonable time) if such funds are available only from current income. A 7 percent savings rate has been the average in recent years. If applied to a $14,500 median family income, this would imply an ability to save only about $1,000 a year. This computation overstates the likely amount of savings since the historical

7 percent savings rate applies to disposable (*i.e.*, after-tax) family income. This does not mean that a young family that is anxious to purchase a home might not make unusual sacrifices over a number of years in order to save at an above average rate, but families that do so are likely to be the ones that would have done so without the benefits of a tax shelter. Nor are the full tax deductions provided by this bill necessary to accumulate the down-payment that is required for the first-time home purchaser under an FHA or VA mortgage (or even, in many cases, a conventional mortgage).

In general, individuals would receive more tax advantages than families from the IHA since individuals would be permitted the same maximum deduction as families although their housing needs presumably are less. Individuals would be in a better position to save money to put into an IHA than a young family with children. Individuals would also benefit from the tax sheltered aspect of the IHA more than families since individuals have a higher marginal tax bracket than families with the same income filing a joint tax return.

Tax Credits As An Alternative to Deductions

In our opinion, some of the problems of the IHA proposal can be dealt with through changes in the provisions of the bill if Congress should find the proposal worth pursuing. If tax credits are used rather than personal tax deductions as the vehicle for the tax shelter, the tax benefits would not depend upon the marginal tax bracket of the individual or family. Likewise, if the tax credits were kept reasonably low, this would reduce the ability of upper income households and enhance the ability of lower and middle income households to benefit from the proposal.

If it is desired to replace tax deductions by tax credits, one possible form this could take is to limit the maximum tax credit per year to $500 (equal to one-third of a maximum $1,500 cash contribution) and a maximum $2,500 lifetime tax credit (equal to one-third of up to a $7,500 cash contribution). The tax credit alternative would pare down the tax benefits of the proposal applied to higher income individuals and families (and correspondingly reduce tax revenue losses) without reducing realistically the tax benefits that would be gained by the average American household under the provisions of the bill as it presently stands. A lower tax credit to individuals might also be justified given the lesser housing needs of individuals.

No Assurance That Funds Come From Income

While the proposed changes above would deal with some of the major problems in the tax proposal, it would still leave open a number of problems that are difficult to deal with. There is nothing in the bill to require that cash deposited in an IHA comes from the current income of an individual or family. There undoubtedly will be many families that already have accumulated assets that meet at least some and possibly all of the downpayment necessary on a home or have received financial help from parents, perhaps specifically for meeting the downpayment on a home. These individuals and families would have a strong incentive to use such funds to build up an IHA to the maximum allowable amount and derive the resulting tax advantages, even though they have no need of the tax advantages to build up a cash downpayment. To the extent this occurs no new funds would would be created for housing despite the tax benefits.

First-Time Home Buyers

As the bill is worded, moreover, we do not see any reference in it to a requirement that the IHA be used for only a first-time home purchase although Senator Brooke refers to the Congressional Budget Office study that indicates that the housing

affordability problem is one that affects only first-time home purchasers generally.

If, in fact, the bill does not restrict the benefits of IHAs to first-time home buyers it means that a large part of the tax benefits provided by the bill would flow to second or third time home buyers who have already benefitted substantially from the rise in equity in their original houses. There are, unfortunately, problems in restricting the benefits of the bill to first-time purchasers. From a practical point of view, the objectives of the bill, namely to help build up an adequate downpayment, would not be served equitably by restricting the benefits to first-time homebuyers in the strict sense of the term. It is possible that a family or one of the two spouses of the family, while still single or perhaps married to another individual, had already owned a house or a condominium or co-operative unit in the past. This housing unit may well have been much smaller than is presently needed by the individual or family and may have been owned only a limited number of years during a period in which home prices were not rising rapidly and, therefore, was not providing a significant equity that could be used to buy a house in today's market.

Moreover, if the house presently needed is much larger than a house owned in the past, the equity built up in the first house might not be adequate even if home prices were rising rapidly during that period of ownership. In addition the ownership of the first house may have been for a very brief period, perhaps one or two years, so that even with rising house prices, no additional equity would have been gotten out of the house because of the fact that closing costs and moving costs could not have been recouped. In addition, not all homes rise in price through time, and an existing homeowner whose house has depreciated in value, or appreciated significantly less than the average house price, might be as much in need of financial assistance for a downpayment on a new home as a typical first-time home purchaser. One gets into particularly thorny situations if one tries to trace through whether a spouse in a family may have received a substantial amount of the increase in equity of a home owned in a previous marriage that was now available to the current family, thereby obviating the need for tax assistance to build up a downpayment. We do not see how an equitable formula for eligibility under the tax benefits of the IHA could readily be devised.

Would Help Buy a More Expensive House

A difficult problem arises from the fact that, for many potential home buyers, the IHA would be used not to make it possible to buy a house but rather to buy a more expensive house than would be possible without the tax benefits of the IHA. This suggests that the bill might be re-worded to permit a build up of a downpayment in the IHA consistent only with the purchase of some modest priced house. However, this suggestion still does not deal with this problem. There is nothing to prevent a household from adding additional funds that it has to the tax benefits provided under the IHA in order to buy a more expensive house than it otherwise would be in a position to do. Thus, the bill, even in modified form, would go beyond merely making homeownership affordable.

To What Extent Would Tax Benefits Stimulate New Money For Downpayments?

We have noted above the fact that cash payments into an IHA could come from parental contributions rather than money saved out of the income of the individual or family. As a practical matter, it is difficult to monitor whether the parental

88-114 O - 77 - 16

gifts to an individual or family are being used to finance the cash contributions to the IHA or are being used for other household expenses. Thus, it is difficult to see how this can be dealt with through redrafting of the language of the bill. Yet, it is unfair for an individual or household to be able to utilize a tax-free gift from parents as a basis for receiving additional tax benefits through the IHA. Tax benefits to stimulate downpayments are difficult to justify when the money does not come out of the household's own income and the tax benefits were not even necessary to build up the downpayment in order to buy a house.

This leads to a more general problem of the degree to which the bill would, in fact, stimulate new savings to meet downpayment requirements for a house or would largely confer tax benefits on funds that would have been raised to a large extent without the tax benefits. Certainly, the bill as presently drafted, based as it is on a deduction rather than on a tax credit, would appear to give relatively little financial incentive to most middle-income Americans to save toward a downpayment. Thus, in its present form the bill would appear to confer tax benefits largely on money that would have been accumulated for a downpayment without the benefit of those tax advantages. Our suggested revision to convert the deduction into a tax credit would certainly provide

more genuine stimulus for new savings in order to accumulate a downpayment by the average American since a tax credit would provide more tax benefits to the average American than would a tax deduction.

Still, we believe that even a tax credit version of this bill would largely end up conveying a windfall tax benefit to those who would accumulate a downpayment on their own without the benefit of a tax advantage and do relatively little to stimulate additional savings for the purpose of meeting downpayments for the purchase of homes. This leads to the view that the benefits of the IHA proposal would be outweighed by its cost in terms of tax revenues foregone and other drawbacks even with the suggested changes above.

Recapture of Tax Benefits

I would like to comment briefly now on the fact that the IHA proposal now has a provision to recapture a portion of the tax benefits. This would be accomplished by reducing the cost basis of the house at the time of sale by the amount of the downpayment which came from the IHA. The purpose of this presumably is to require the homeowner who has had the tax benefits of

the IHA to repay at least part of these tax benefits to the Federal government. However, as a practical matter, taxation of capital gains on a house can be deferred for a very lengthy period of time, and in many cases, even for the full life of the individual or family. Moreover, any capital gain on a house that is taxed at some future point of time, particularly if it is a lengthy period of time away, represents a very small amount in terms of the present value of that tax. From the Federal Government's point of view, the fact that any capital gains tax may be deferred 30 or 40 years means that the Federal Government will be paying interest on additional Government debt during the entire period to make up for the effects of that foregone tax revenue. Finally, the capital gains tax is at a lower tax rate than the tax rate at which the tax benefits are computed in building up the IHA and is likely to be paid after an individual has retired and is in a lower tax bracket.

Given the substantial financial gain from the build-up of equity in a house that is obtained by an individual or family utilizing the IHA, it may be considered appropriate that the Federal government receive a larger return on the tax foregone than it appears to do under the present bill. This is even more so where it is an upper income individual or family that is benefitting from the increased ability to purchase a home. Thus, we

would strongly suggest that, if Congress desires to pass some version of this tax proposal, the bill be modified to provide a higher recapture of gains from homeownership made possible by the IHA.

Conclusion

As our discussion above indicates, we do not believe that the downpayment problem is a major obstacle to homeownership affordability today. It is a problem that can be dealt with by most households if need be by deferring a housing purchase for a number of years. Neither do we foresee any major new downpayment requirement decreases over the future since these are already low historically, since further major decreases could result in a significant foreclosure problem, and since, equally important, there is a trade-off between downpayments and monthly payments the effect of which is that still further declines in downpayments would raise required monthly payments.

As we have discussed, the trade-off problem exists under GPMs as well as standard fixed payment mortgages. Hence, we do not expect the introduction of GPMs on a broader scale to reduce significantly downpayment requirements. However, based on present

results of our AMIRS project, we believe that a permanent program of FHA-insured GPMs would be helpful. While such GPMs would be expected to carry downpayments in excess of those on FHA-insured standard fixed payment mortgages, given negative amortization in early years, we believe that any statute authorizing a permanent FHA-insured GPM program should not require that GPMs carry a downpayment higher than that for standard fixed payment mortgages. This would give HUD maximum flexibility in designing an array of GPMs with varying graduation rates and downpayments. In practice, a downpayment of at least 10 percent might be common for GPMs, but GPMs with a lower downpayment should be allowed as well since they may be suitable for households with certain wealth and income characteristics.

Finally, we believe that the IHA has too many problems to be a useful means of dealing with such downpayment problems as households currently have. Even with appropriate modification, it would provide only minimal benefits to lower and middle-income households and result in a tax loss that could not be justified by the benefits that would flow from the proposal.

Outline of Tables

Federal Home Loan Bank Board
Office of Economic Research
March 31, 1977

Table 1. Estimates of the Number of Families and Unrelated Individuals Renting in the U.S. in 1968, According to the Amount of Financial Assets, Income Level, and Increase in Income (Thousands)

Financial Assets, 1968 (dollars)	Level of Income, 1968	Average Annual Increase in Income, 1968-75: Less Than $300	Between $300 and $1,000	Over $1,000
zero	Less than $3,500	2,077	1,264	3,379
	$3,500 to $7,000	934	466	100
	Over $7,000	67	18	0
$0 to $1,000	Less than $3,500	0	17	482
	$3,500 to $7,000	98	46	121
	Over $7,000	81	36	36
$1,000 to $2,000	Less than $3,500	0	20	1,118
	$3,500 to $7,000	157	505	141
	Over $7,000	362	153	75
$2,000 to $3,000	Less than $3,500	0	4	1,438
	$3,500 to $7,000	187	382	426
	Over $7,000	351	406	148
$3,000 to $5,000	Less than $3,500	0	25	2,287
	$3,500 to $7,000	273	655	803
	Over $7,000	874	721	744
$5,000 to $10,000	Less than $3,500	4	0	4,400
	$3,500 to $7,000	164	219	973
	Over $7,000	1,568	1,878	2,705
Over $10,000	Less than $3,500	0	0	2,811
	$3,500 to $7,000	62	54	158
	Over $7,000	1,135	839	2,656

Sources and Notes: The data were supplied by Professor Jim Smith, Penn State University, on leave at Yale University, as part of his "Demographics Study" for the Alternative Mortgage Instruments Research Study. The primary data come from the Panel Study of Income Dynamics for 1968-1975. The Panel Study consists of a national sample of over 5,000 families being conducted by the Survey Research Center, University of Michigan, Ann Arbor, Michigan. Financial assets consists mainly of cash, checking and savings accounts, and stocks and bonds, as estimated based on a number of socio-economic characteristics of households. The methodology for estimating the amount of financial assets is explained in Guy Orcutt, Steven Caldwell, and Richard Wertheimer, Policy and Experimentation Through Micro Analytic Simulation, Urban Institute, Washington, D.C., 1976, and is based on wealth data in the 1962 Survey of Financial Characteristics of Consumers, Board of Governors of the Federal Reserve System.

Income is measured as "take-home pay," net of taxes. The level of income and its average annual increase are the intercept (in 1968) and the slope, respectively, of the regression of income on time for the 2,711 families in the sample who were originally renters.

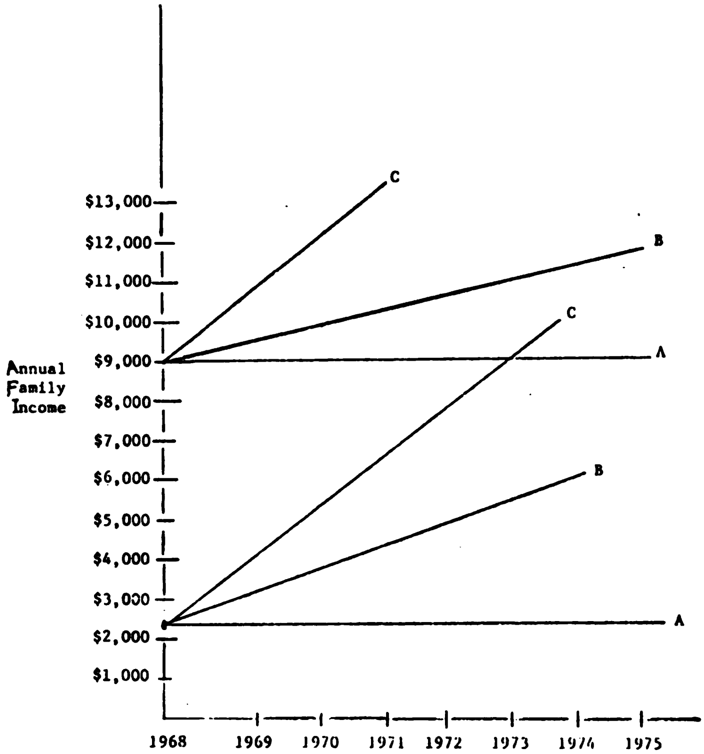


Figure 1. Alternative Income Trajectories, 1968-1975.

Table la. Estimates of the Average Annual Percentage Increase in Income of Families and Unrelated Individuals Renting in the U.S. in 1968 over the period 1968-75, According to the Amount of Financial Assets, Income Level, and Increase in Income (%)

Financial Assets, 1968 (dollars)	Level of Income, 1968	Average Annual Increase in Income, 1968-75: Less Than $300	Between $300 and $1,000	Over $1,000
Zero	Less than $3,500	6.5 %	32.2 %	1730.9 %
	$3,500 to $7,000	-0.4	12.0	25.9
	Over $7,000	-5.1	7.7	0.0
$0 to $1,000	Less than $3,500	0.0	16.1	1217.8
	$3,500 to $7,000	0.8	12.6	25.4
	Over $7,000	-4.3	8.0	18.1
$1,000 to $2,000	Less than $3,500	0.0	21.7	3987.7
	$3,500 to $7,000	1.5	11.7	29.0
	Over $7,000	-3.3	6.6	16.6
$2,000 to $3,000	Less than $3,500	0.0	28.6	19170.0
	$3,500 to $7,000	1.3	12.3	27.7
	Over $7,000	-1.7	7.2	13.9
$3,000 to $5,000	Less than $3,500	0.0	26.5	7306.5
	$3,500 to $7,000	-0.4	11.0	32.1
	Over $7,000	-2.0	7.7	17.5
$5,000 to $10,000	Less than $3,500	-8.0	0.0	34739.0
	$3,500 to $7,000	1.6	10.4	35.3
	Over $7,000	-2.0	6.1	15.8
Over $10,000	Less than $3,500	0.0	0.0	-15807.0*
	$3,500 to $7,000	-1.0	12.1	42.0
	Over $7,000	-3.6	4.9	13.9

The computations for each cell were the mean slope ÷ mean intercept x 100. The "slope" is the average annual increase in income for a family and the intercept is its 1968 income level.

*negative base

Table 1b. Estimates of the Number of Families and Unrelated Individuals Renting in the U.S. in 1976, According to the Amount of Financial Assets, Income Level, and Increase in Income (Thousands)

Financial Assets, 1976 (dollars)	Level of Income, 1976	Average Annual Increase in Income, 1968-75		
		Less Than $300	Between $300 and $1,000	Over $1,000
Zero	Less than $3,500	2796	1701	4548
	$3,500 to $7,000	1257	628	134
	Over $7,000	90	24	0
$0 to $1,000	Less than $3,500	0	23	649
	$3,500 to $7,000	131	62	163
	Over $7,000	109	48	48
$1,000 to $2,000	Less than $3,500	0	26	1505
	$3,500 to $7,000	211	680	190
	Over $7,000	487	206	101
$2,000 to $3,000	Less than $3,500	0	5	1935
	$3,500 to $7,000	251	514	573
	Over $7,000	472	547	199
$3,000 to $5,000	Less than $3,500	0	33	3079
	$3,500 to $7,000	367	881	1080
	Over $7,000	1176	971	1002
$5,000 to $10,000	Less than $3,500	5	0	5923
	$3,500 to $7,000	221	295	1309
	Over $7,000	2111	2528	3641
Over $10,000	Less than $3,500	0	0	3784
	$3,500 to $7,000	83	74	213
	Over $7,000	1528	1130	3575

Income Increases below 5% per year

Income Increases of 5-10% per year

Income Increases Above 10% per year

Total in 1976: 55.1 Million Renters
Less than 5%: 8,499,000 or 15%
5-10% ..... 8,250,000 or 15%
> 10% ..... 38,573,000 or 70%

TECHNICAL APPENDIX

Preliminary and Partial Internal Working Draft:
Analysis of Fixed Interest Rate Mortgage Instruments*

by

Al Field
Henry J. Cassidy

Office of Economic Research
Federal Home Loan Bank Board

March 1977

* This draft is being developed as part of the Alternative Mortgage Instruments Research Study (AMIRS)

Analysis of Fixed Interest Rate Mortgage Instruments

Mortgage instruments can be divided into two broad categories based on whether they use a fixed or variable interest rate. The rate we refer to is the debit rate, the rate at which interest changes are computed, which is not necessarily the same rate used for computing the periodic payments. Besides the standard fixed payment mortgage instrument (SFPM), the major types of fixed rate instruments are the graduated payment mortgages (GPMs) and deferred interest mortgages (DIMs). GPMs and DIMs represent alternative ways of reducing initial payments below those required by a standard instrument with the same debit rate. Lowering the initial payments necessarily requires higher payments at some later date.

For GPMs, the periodic payment increases at a predetermined rate (the graduation rate) over a particular portion of the life of the loan. The initial payment falls as either graduation rate or the number of years that payment graduations are in effect increases. To illustrate the effect of these parameters we have plotted the payment stream and outstanding principal for three GPMs and compared them to a SFPM. Each is computed at a 9 percent debit (contract) rate over 30 years for a 30,000 dollar loan.

In Charts 1 and 2 we have used a GPM with a 4½ percent graduation rate for all 30 years.[1] The first year's payments are more than 1,000 dollars less than those of the standard instrument; however, if the mortgage is held for the entire 30 years, the final payments are over twice as high. Although this appears to be a drastic increase, the payments would be stable in terms of purchasing power if inflation averaged 4½ percent over the period. People renting during such a period would expect similar rent increases. The more serious drawback to letting the graduation period extend over the full life of the loan is shown in Chart 2. The payments during the first part of the loan are insufficient to cover the interest changes and the outstanding balance increases to almost 38,000 dollars and does not fall below the original 30,000 dollar loan amount until the twenty-third year. Although real indebtedness will fall, assuming even moderate rates of inflation, borrowers and lenders are familiar only with declining balance loans and might be reluctant to enter into such substantially different contracts.

Reducing the period for which the graduation rate is in effect can substantially reduce the amount of negative amortization and still retain most of the benefits of reducing the initial payment.

---

[1] The 30-year GPM is sometimes referred to as the standard GPM.

Chart 1

Standard Graduated Payment Mortgage (GPMS) - Payment Stream

* = GPMs (30-year, 4½%) Annual Payment

+ = SFPM Annual Payment

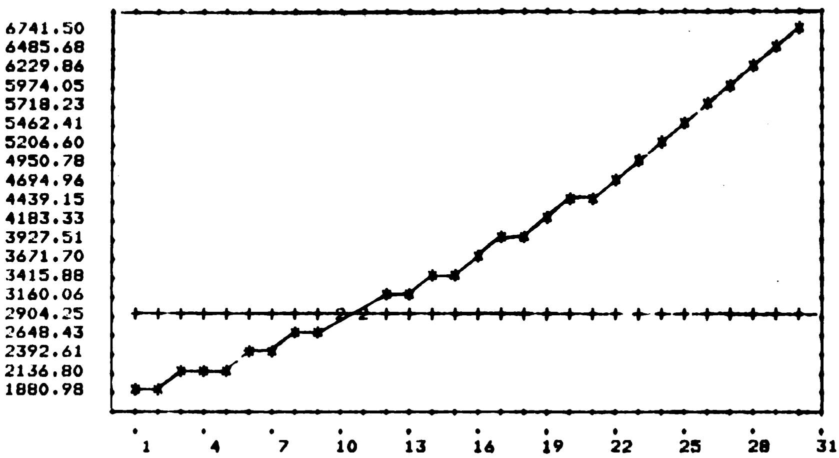
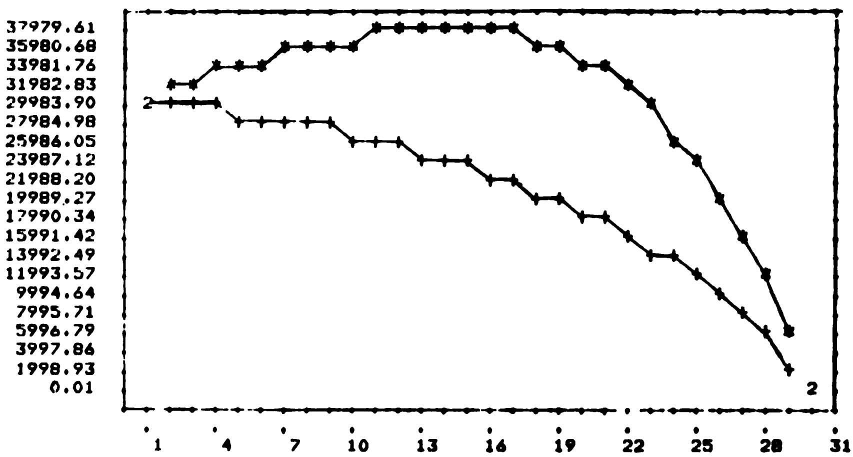


Chart 2

Standard Graduated Payment Mortgage (GPMS) - Outstanding Principal

\# = GPMS (30-year, 4½%) Annual Payment

\+ = SFPM Principal at End of Year



In Charts 3 and 4 we have plotted the payment streams and outstanding principal for two GPMs, the first using a 3 percent graduation rate for the first 10 years and the second using a 7½ percent graduation rate for the first five years, and again compared them to a standard instrument with the same debit rate of 9 percent.[2] The initial payment reductions remain substantial: over 800 dollars for the 10-year graduction period and about 500 dollars for the 5-year period. Although negative amortization occurs in both cases, it is much lower than in the 30-year example: the maximum balances are 31,243 and 30,933 dollars for the 5-year and 10-year graduation periods, respectively. There is still more risk than on the standard instrument, but the problem seems to be manageable, as we discuss in a later section.

Deferred interest mortgages have the same intention as the GPMs, but instead of using a payment graduation rate, they use a lower rate to compute payments than that used to compute interest charges over the first part of the loan, usually five years. Thus if the initial payment rate is 7 percent, payments during the first five years will be the same as those on a 30-year, 7 percent mortgage; after five years payments will increase substantially to make up for

---

[2] Also known as the modified GPM or HUD-FHA GPM. The graduation rates and terms used are two of the five authorized by HUD in its experimental GPM plan. Interest charges are computed on an annual basis and are slightly higher than if computed on a monthly basis.

88-114 O - 77 - 17

Chart 3

Modified Graduated Payment Mortgage (GPMM) - Payment Stream

*. = GPMM (10-year, 3%) Annual Payment

+ = GPMM (5-year, 7½%) Annual Payment

. = SFPM Annual Payment

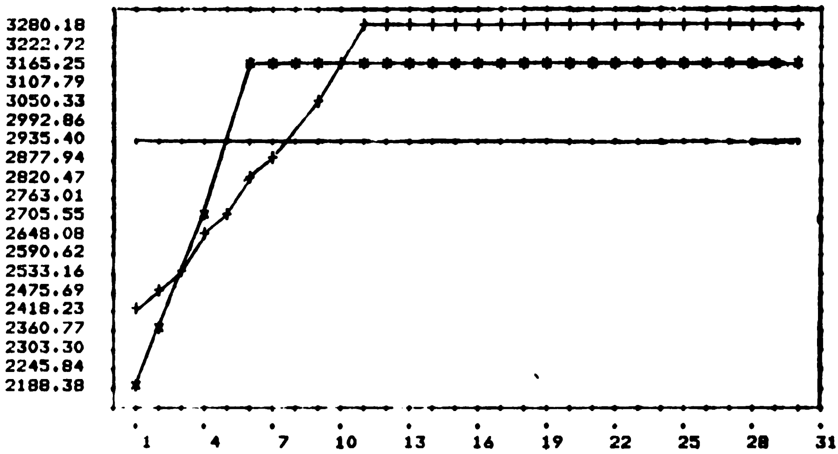


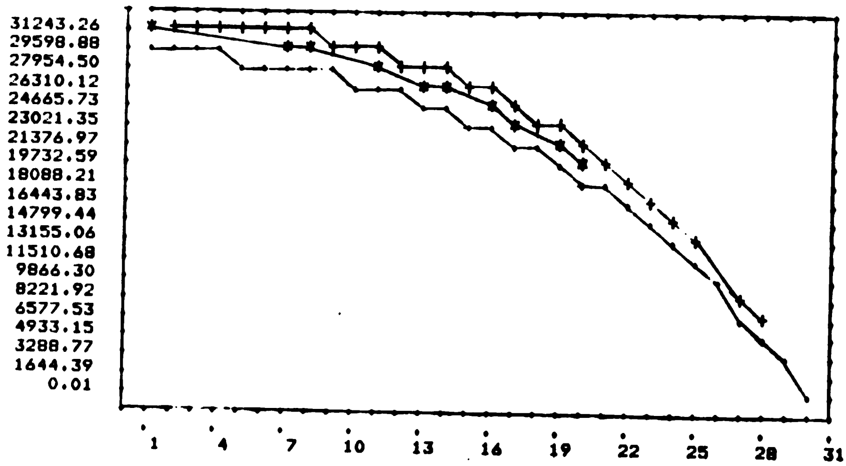
Chart 4

Modified Graduated Payment Mortgage (GPMM) - Outstanding Principal

* = GPMM (10-year, 3%) Principal at End of Year

\+ = GPMM (5-year, 7½%) Principal at End of Year

. = SFPM Principal at End of Year



the lower initial payments.

In Charts 5 and 6 we have again plotted the payment streams and outstanding balances for two types of deferred interest mortgages, comparing them with a SFPM. All instruments use a 9 percent debit rate and a 30-year term. The first deferred interest loan uses a 7 percent payment rate for the first five years; the second uses an initial payment rate of 8.1 percent, selected so that the first five years' payments exactly cover the interest charges.[3] As Chart 5 shows, using the 7 percent payment rate yields a substantial (500 dollar) reduction in the initial payment and the interest-only loan a smaller reduction of about 200 dollars. Moderate amounts of negative amortization occur in the first loan and no amortization occurs for the second. The particular drawback in these instruments occurs when payments convert to a fully-amortized basis in the sixth year; the increases shown in Chart 5 are over 800 and 300 dollars for the two types of loans, respectively. Even though the increases are known at the time the loan is made, events out of the control of the borrower may cause substantial difficulties in meeting the increased payments. Although the increase is not of an unmanageable

---

[3] The interest-only loan is commonly referred to as two-step GPM or the flexible payment mortgage. See Henry J. Cassidy and Josephine M. McElhone, "The Flexible Payment Mortgage," Federal Home Loan Bank Board Journal, August 1974, pp. 7-11.

Chart 5

Deferred Interest (DIM) and Two-Step (GPM2) Mortgages - Payment Stream

* = DIM (5-year, 7%) Annual Payment

+ = GPM2 (5-year) Annual Payment

. = SFPM Annual Payment

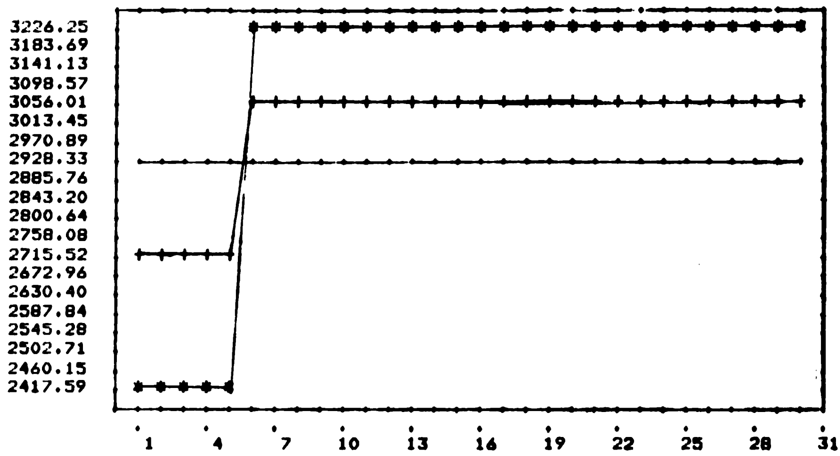


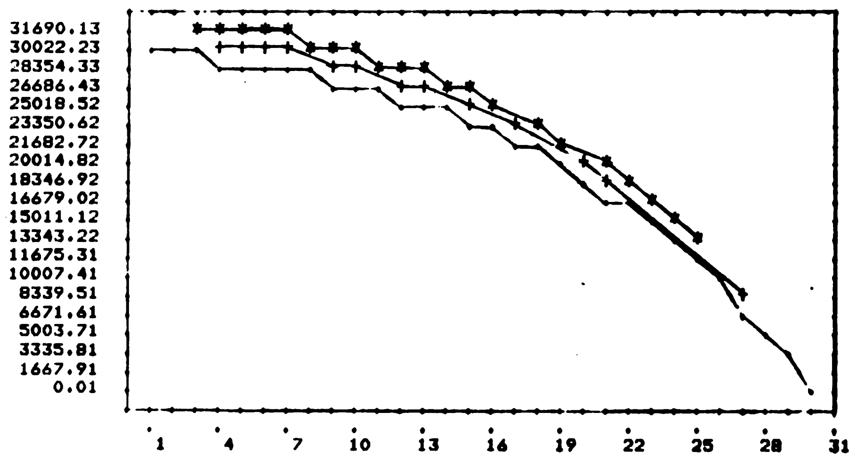
Chart 6

Deferred Interest (DIM) and Two-Step (GPM2) Mortgages - Outstanding Principal

* = DIM (5-year, 7%) Annual Payment

+ = GPM2 (5-year) Principal at End of Year

. = SFPM Principal at End of Year



size, a 5-year GPM seems to provide similar benefits and its smoothly increasing payments avoid this potential problem.[4]

In general, it appears that the 5-year and 10-year graduation period GPMs are somewhat more practical at the current time than the 30-year GPM or the deferred interest loans. In addition, they are currently being tested by HUD and are the subject of current legislation to extend the experimental program. For this reason we will concentrate on these types of GPMs for the remainder of the analysis. It is unlikely that the omission of the other instruments will have any effect on our conclusions.

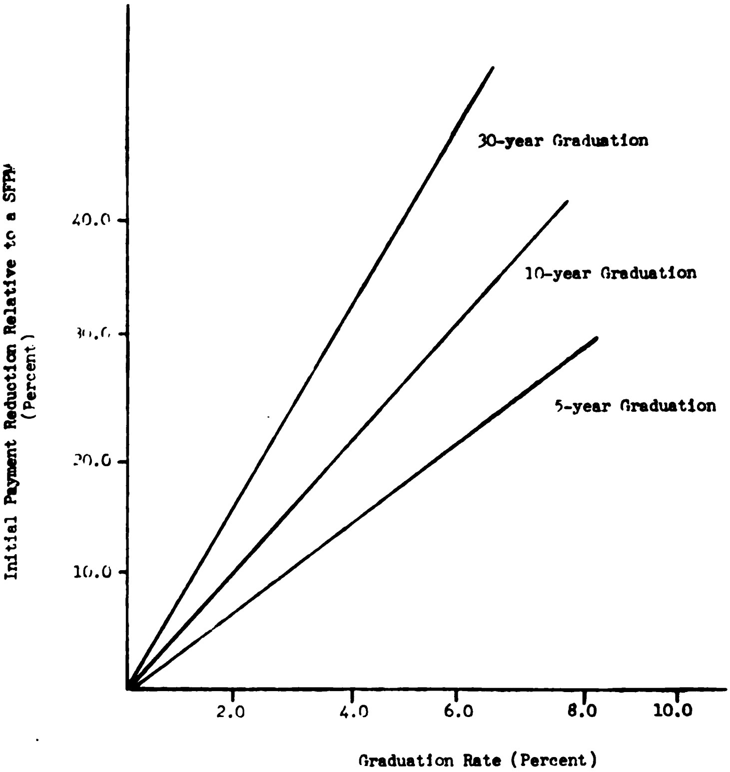
Payment Pattern

The initial payment reduction is the primary benefit of GPMs. In Chart 7 we have plotted the initial payment reductions of three GPMs relative to a standard instrument. The contract rate is again 9 percent, and the term 30 years (the mortgage amount does not affect the slopes). The chart clearly shows the dramatic effect of increasing the graduation period; however, it also demonstrates that substantial reductions can be achieved by using only a 5-year graduation period.

[4]This difficulty is substantially reduced if the deferred interest is subsidized or insured by the government; however it would be impractical to compare it with other instruments unless they had similar features.

Chart 7

GPM Initial Payment Reduction



Estimating the potential impact of the initial payment on housing demand is difficult, since a number very tentative assumptions must be made. a 9% standard mortgage of 30,000 dollars requires annual payments of 2,920 dollars. Using a 10-year, 3 percent GPM reduces the initial payment to 2,428 dollars. If we limit annual housing expenses to 30 percent of income, the decrease of 512 dollars in the initial mortgage payment is equivalent to a 1,700 dollar increase in income in terms of mortgage-carrying capability.

There are several ways we can analyze this increase. Including taxes, insurance, heat and utilities in housing expense and applying the 30 percent ratio, the income requirement would be reduced from 15,230 dollars to 13,530 dollars.[5] This would increase the number of families eligible for that size of mortgage. Alternatively, a family with an income of 13,530 dollars would be able to obtain that mortgage almost 2½ years earlier, assuming its income grows at a 4½ percent annual rate.

A third way is to compute how much more expensive a house a family would be able to purchase. Letting mortgage principal and

---

[5] This is the definition of housing expense used in the FHA Section 203b program. The values of income, mortgage terms and housing expenses used here approximate the averages on new homes loan insured during the fourth quarter of 1975. The 30 percent ratio of housing expenses to income is halfway between the average of 25 percent and the maximum of 35 percent. Data are published in FHA Trends of Home Mortgage Characteristics.

interest payments equal 5/8 of total housing expenses, the additional annual mortgage payment would be 322 dollars. A GPM payment of 2,730 dollars corresponds to a 34,000 dollar mortgage, and a 90 percent loan-to-value ratio allows purchase of a 37,775 dollar house - an increase of about 4,500 dollars in the price of the home purchased. The household, of course, would need an additional 450 dollars in downpayment to hold the loan-to-value ratio constant.

There is no reason to believe, however, that increases of these magnitudes will be realized. For example, some households might not alter the size or timing of home purchase but plan to spend more on maintenance and improvements during the early years of the loan, or just more on other goods more important to them at that point in their life cycles. The realization of the maximum increases in housing expenditures requires that homebuyers view a payment decrease as being equivalent to an income increase and that the higher future payments do not dampen their demand for houseing. This result might be based on rising income expectations that could not be taken into account by standard lending practices. It also requires that these slower-amortizing mortgages will be offered on the same terms (contract rate, duration, fees, loan-to-value ratio, etc.) or that buyers are not sensitive to the adjustments that take place. We will evaluate these qualifications on a more aggregated basis in the concluding section.

The increasing nominal payments of these instruments introduces additional risk, even in the presence of an inflation that affects all prices equally. In contracting for payment increases of 7½ percent for the first 5 years, for example, the household is assuming its income will rise by at least that much or that it can afford to spend a rising proportion of its income on housing. It will experience dislocations of its planned purchasing pattern to the extent that those expectations are not realized. In the next two charts, numbers 8 and 9, we have plotted the payment-to-income ratios for three different income growth scenarios, first for the 10-year, 30 percent GPM, and then for the 5-year, 7½ percent GPM. Initial income is 15,000 dollars; in the first scenario, it grows at an average rate of 4½ percent annually. We use this as our normal or "expected" scenarios, reflecting modest growth without major economic disturbances. The resulting "expected" payment-to-income ratio is the middle line in each chart; it begins at about 15 percent and rises only slightly during the first 5 years of the 7½ percent GPM and then falls throughout the rest of the 30 years. A high rate of inflation, assuming it was unexpected and not reflected in the initial rate, is a benefit to the borrower in this context; the ratio falls rapidly throughout the period. We used a 7 percent income growth rate in the latter case; if instead income grows at only 2 percent, substantially larger amounts of

Chart 8

Graduated Payment Mortgage (10-year, 3%)
Payment to Income Ratios

* = Income Growth Rate = 4½%
\+ = Income Growth Rate = 7%
. = Income Growth Rate = 2%

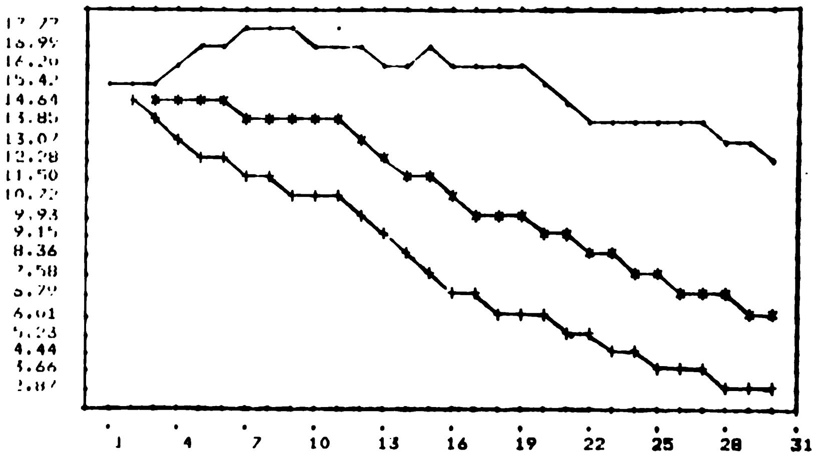
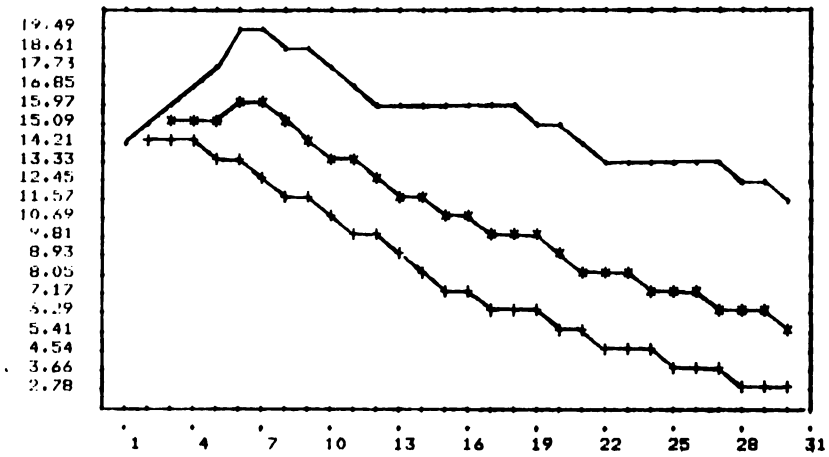


Chart 9

Graduated Payment Mortgage (5-year, 7½%)

* = Income Growth Rate = 4½%
+ = Income Growth Rate = 7%
. = Income Growth Rate = 2%



purchasing power must be devoted to mortgage payments. In the 5-year GPM, the ratio jumps quickly up to 19½ percent and never falls below 11½ percent. The 10-year GPM produces a smaller initial rise but also does not fall as far.

If we had plotted the GPM with a 30-year graduation here, the results would be even more severe. This was the major concern in our decision not to extensively analyze it. Similarly, the unsubsidized deferred interest loan could cause major problems when the jump in payments coincides with a substantial decline in income growth.

Yield

Yield considerations require somewhat less attention for these instruments, not because they are unimportant, but because the yield characteristics of GPMs are very similar to those of the standard instrument. In the absence of fees and prepayment penalties their yields are identical to the standard instrument regardless of the prepayment date. If initial fees are charged and amortized over the life of the loan, the yield for a prepaid GPM will be up to 1 or 2 basis points higher than on a standard instrument. If prepayment penalties are computed as a fraction of the oustanding balance, then prepayment penalties will be slightly higher for the GPM. Although there could be a difference of a couple hundred dollars in the actual penalty, the amount is

insignficant when spread over the life of the loan.

A lender dealing exclusively in GPMs would be able to make fewer numbers of loans than one with the same dollar volume of standard loans, since GPMs have a higher average outstanding balance. Similarly if he had switched to GPMs all at once, he would have much lower cash flows in the early years. The effect of introducing GPMs, however, would be very small since they could be phased in only gradually and are not expected to supplant, or even dominate, other instruments.

Although the discounted present value of the payments is identical for each instrument with the same fixed debit rate, deferring payments into the future will produce higher average payments. As was mentioned before, borrowers may not be indifferent to these higher future payments. Just as we did with the initial payments, in Chart 10 we have plotted the average payments for three types of GPMs relative to the average payment on a standard instrument. The terms are 9 percent for 30 years on each loan. It is obvious why high graduation rates and long graduation periods are generally viewed as being unacceptable. There are definite limits on the extent to which we are willing to trade future for current consumption.

Inflation has an pronounced impact on the average real cost of these instruments. In Chart 11 we have plotted the

Chart 10

GPM Nominal Payments

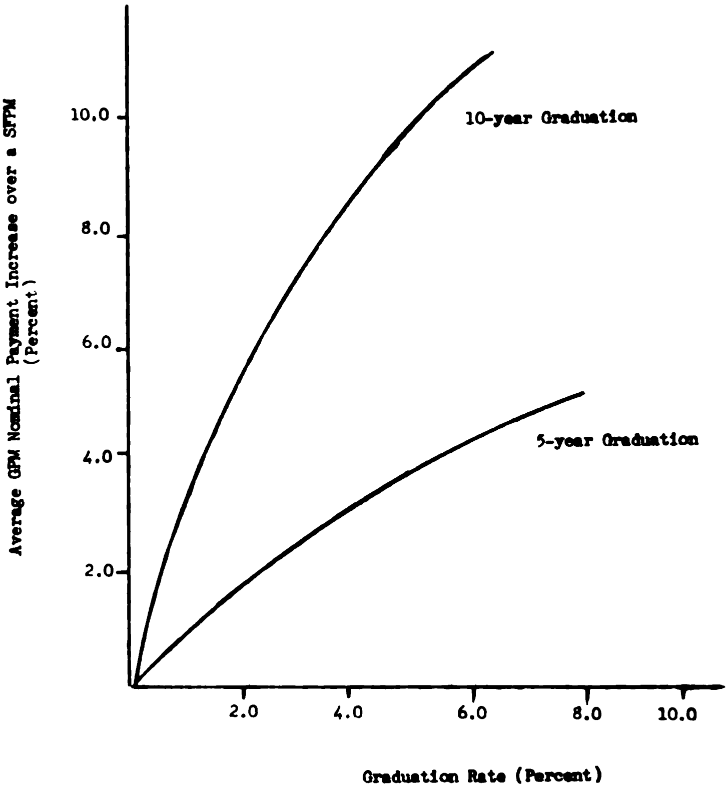
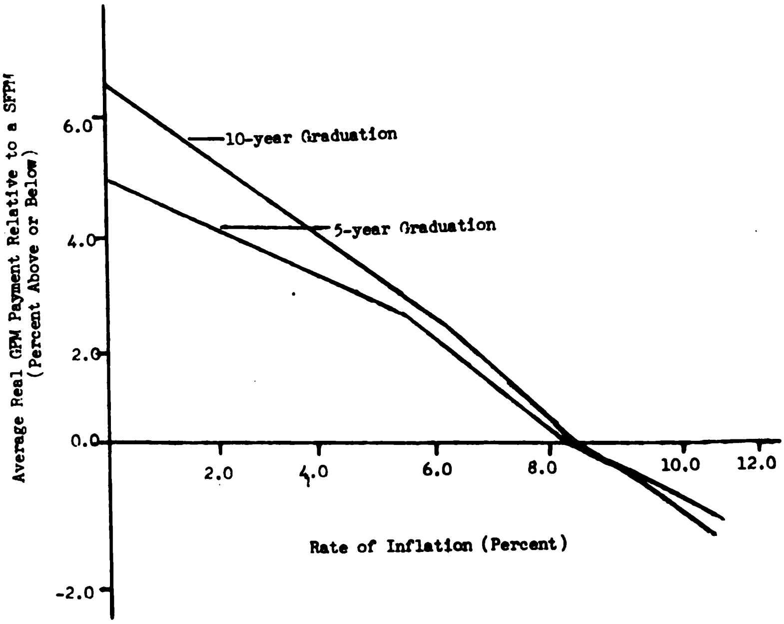


Chart 11

GPM Real Payments



88-114 O - 77 - 18

percentage difference in average real GPM payments and payments on the standard instrument. At low rates of inflation, the previous conclusion holds, but as the rate of inflation increases over 8 percent the GPMs cost less in average real terms. At higher rates, the average real cost on the 10-year GPM falls below that of the 5-year, since it defers payments more.

These relationships become perverse at very high and very low, including negative, rates of inflation because in setting the contract rate at 9 percent we have implicitly assumed that inflation would average in the neighborhood of 4 to 6 percent. If higher inflation was expected, the contract rate would be higher and the reversal would occur at much higher rates. Nevertheless, GPMs become much more attractive when we take inflation into account, either using average payment measures or payment-to-income ratios.

Risk

Risk considerations for GPMs are largely those of default risk. Interest rate risk is a less important subject since GPMs are virtually identical to the standard instrument. It should be stressed, however, that for GPMs and all other fixed rate instruments, borrowers still are subject to interest rate risk. There is always an opportunity cost (or gain) of paying the contract rate as opposed to the current market rate. Over the last decade, rising interest rates have kept market rates above average rates on existing contracts.

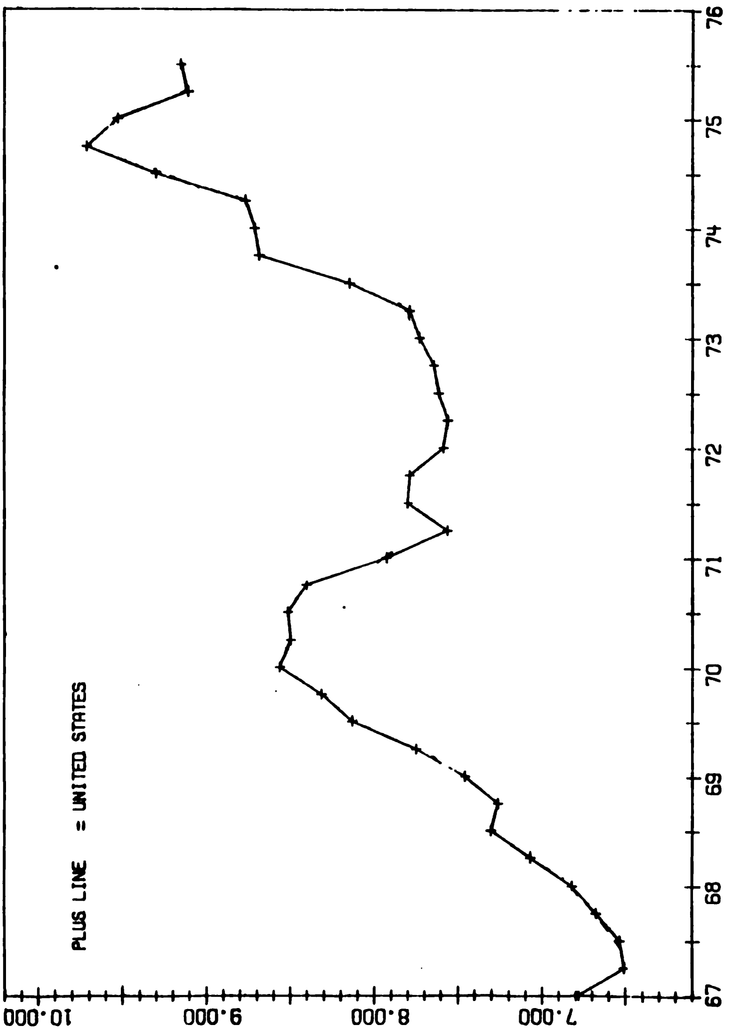
However, borrowers who obtained mortgages in 1974 and 1975 at rates sometimes above 10 percent would be currently better off with a variable rate instrument.

Borrowers face interest rate risk directly when they move and have to refinance. A fixed rate contract allows them some latitude in timing their move to coincide with a period of moderate or falling interest rates. However, many borrowers, particularly young families, have limited flexibility in this regard because their moves are connected with employment transfers. For them there is a distinct possibility that the "luck of the draw" will cause their moves to coincide with cyclical peaks in interest rates. In Chart 12 we have plotted the effective interest rate on conventionally financial existing homes from 1967 to 1976. Those who purchased a mortgage in 1967 or 1972 have benefitted from fixed rates whereas those who purchased in 1970 or 1975 may have suffered because of them.

It is difficult to estimate default risk for GPMs because we have no historical experience with loans that may have negative amortization. Other things being equal, however, we assume GPMs are more risky because of the additional variation in the payment stream and the higher outstanding balance.

The effect of the additional variation in payments on default depends in part on how borrowers adjust their housing purchases using

GRAPH ·12. EFFECTIVE LENDING RATE. EXISTING HOMES (SLA'S)



a GPM. If they use it to increase their real housing expenditures by buying more expensive homes and buying them earlier, default risk will be higher. On the other hand, if they use it at least partly to avoid being "house poor" during the early years of the contract, default risk will be reduced. We previously discussed the effect of unexpected variations in income on the payment to income ratio; it was largely upon that basis that we concluded the 30-year graduation period GPM and the deferred interest loans are somewhat less desirable than the 5-year and 10-year versions. Although lower initial payment-to-income ratios might be required, these GPMs would quickly defeat the original purpose of the instrument.

In Charts 13 and 14 we have plotted the loan-to-property value ratios under several property value appreciation scenarios for the 5-year and 10-year GPMs. The value appreciation rates are 2, 4½, and 7 percent; the 4½ percent rate again represents a normal or expected scenario. Each loan is assumed to have 10 percent down. Even under the 7½ percent GPM, a 2 percent annual increase in property value is adequate to prevent the loan balance from exceeding the property value. For the lower growth rate however, the borrower's rate of equity accumulation is much slower. If low rates of property appreciation coincide with low rates of income growth, as would occur from a balanced decline in the rate of inflation, default risk would be even higher in the critical first five years.

Chart 13

Graduated Payment Mortgage (10-year, 3%)
Principal to Property Value Ratios

* = Property Appreciation Rate = 4½%
\+ = Property Appreciation Rate = 7%
. = Property Appreciation Rate = 2%

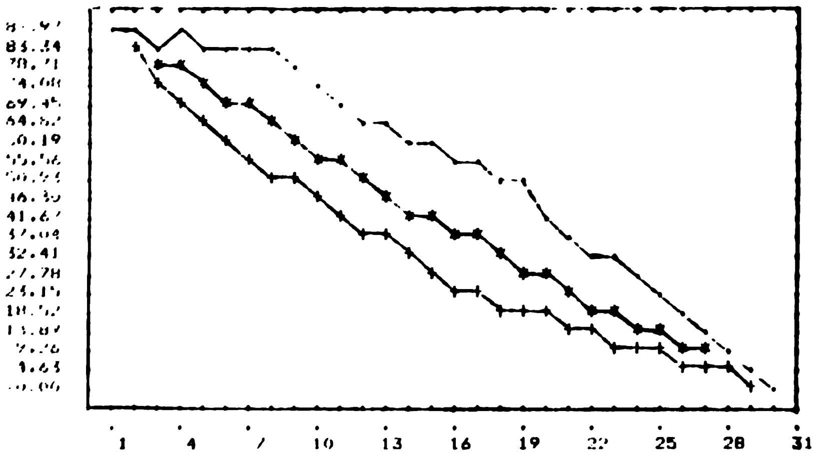
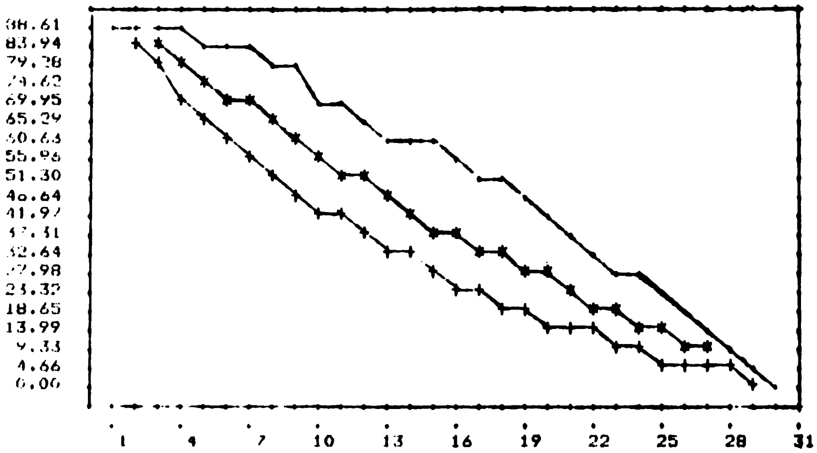


Chart 14

Graduated Payment Mortgage (5-year, 7½%) -
Principal to Property Value Ratios

\# = Property Appreciation Rate = 4½%
\+ = Property Appreciation Rate = 7%
. = Property Appreciation Rate = 2%



Although we have no quantitative measures of GPM default probabilities, we believe it is certainly in an acceptable range.[6] Proper design of the instruments to be made available should make them attractive to both borrowers and lenders. The loan-to-property value ratio is the key parameter to be dealt with. Current underwriting practice for the standard instrument explicitly considers only current income and the initial loan-to-value ratio. One intention of introducing AMIs has been to allow for consideration of future income. If the same consideration is made of future property values, then GPMs may be much less risky then their critics contend.

There are several ways of limiting default risk on GPMs that we might consider. One is to use only those graduation rates and graduation periods that do not result in negative amortization.

---

[6] Follain and Struyk, using simulated current loan-to-property-value ratios have estimated the following default rates over a hypothetical 10-year period. (Figures in percent of loans originated.)

	95 Percent Loan		90 Percent Loan	
	5 years	10 years	5 years	10 years
Standard Instrument	1.96	2.16	1.13	1.31
Graduated Payment	3.18	3.42	1.49	1.70

See James Follain and Raymond Struyk, "Homeownership Effects of Alternative Mortgage Instruments," Working Paper 802-13, Washington, D.C.: The Urban Institute, February 1977.

Although this would certainly reduce default risk, it would also virtually nullify GPMs as a significant improvement in the choices available to borrowers and lenders. Federal savings and loan associations are already authorized to make loans for which the first five years' payments cover only accumulated interest. For loans in the 9 percent, 30-year range, the initial payments on the standard instrument are largely devoted to interest, and only very small further reductions would be achieved by GPMs. They would become more effective at lower interest rates and shorter terms, but their usefulness should not be so dependent on favorable economic conditions.

A second way is to require an additional downpayment such that the loan balance does not exceed the original value of the property. This is much less restrictive and is essentially what HUD has done in requiring small additional downpayments on their experimental GPM program. The initial loan-to-value ratio for the plan with the most negative amortization, the 5-year 7½ percent GPM, was reduced from 97 to 93.5 percent for 25,000 dollar houses and from 92 to 88 percent for 45,000 dollar houses. Higher graduation rates or longer graduation periods would increase the downpayment such that it might lessen the desirability of the instrument. However, borrowers are unlikely to select instruments with much higher rates or longer periods because of the rapid rise in the total cost of the loan.

Finally, the minimum downpayment can be set such that the outstanding balance does not exceed the expected property value at any point during the life of the loan. Although this probably would not make substantial differences in initial payments or required downpayments over the second method, it would represent a shift in explicit underwriting standards. One effect might be in basing mortgage insurance premiums on expected property appreciation and revising them periodically on the basis of realized appreciation. Such practice is common for other forms of insurance and is justifiable on the grounds of economic efficiency. However, it does raise equity considerations and probably would not be acceptable for federally administrated programs. After having time to evaluate the HUD experimental programs, however, private insurers may prefer such an arrangement. Such considerations will also be more important if line-of-credit provisions are to be added to mortgage instruments.

Robustness

The HUD experimental GPMs are being offered at the same contract rate as other mortgages under the Section 203 program. However, there is some reason to believe they will ultimately carry a higher contract rate or require higher initial fees either as a result of experience or in the absence of FHA insurance in the conventional market. If they are to be viable in a broader market, it is necessary that they

retain their desirable characteristics in the presence of price adjustments. As we discussed under yield, initial fees affect the GPM yield in almost the same magnitude as the yield on the standard instrument. Increasing the fees on the 10-year, 3 percent GPM from 3 to 4 percent, for instance, increases the yield (cost) from 9.78 to 10.04 percent for prepayment after 5 years and from 9.47 to 9.63 percent after 10 years. Increasing the contract rate on the same instrument from 9 to 9½ percent on a 30,000 dollar mortgage raises the first year's payments by a total of 100 dollars but still leaves them 400 dollars below a standard instrument at 9 percent. To be brief, they do retain most of their benefit under unfavorable pricing assumptions.

Senator BROOKE. Thank you, sir. I just want to say that the bill does provide that it be available only for a first purchase, and I am seriously considering a limitation on the income of the family that would be eligible for an IHA.

I'd say if Ken Rosen is the supreme pessimist, you're the supreme optimist about the future. I'd like to believe you're right. As you know, the inflation rate for the last 5 years has been around 7 percent and we just don't have much encouragement about what's going to happen. We're going to have at least a 3-percent inflation rate, I think most economists agree. You economists are almost like politicians. You can come out either way you want to on any issue, but certainly on this one you and Dr. Rosen see it differently.

Dr. Shalala, it has been suggested in Administration testimony that it may be more efficient to provide FHA insured low downpayment loans to young households rather than to encourage them to save the downpayment through an IHA. Now it is my understanding from an academic study by Professor George VonFurstenberg, that the risk of default rises two or three times as we move from a 10-percent to a 5-percent downpayment loan.

Do your studies agree with this assessment and is that not a matter of concern to the Department of Housing and Urban Development?

Dr. SHALALA. I don't personally know the answer to that question. Could I refer the question to Dr. Robert Buckley from the Department?

Senator BROOKE. Yes. Dr. Buckley.

Dr. BUCKLEY. I think basically that we agree with Mr. VonFurstenberg's findings. However, I think the VonFurstenberg findings refer to the sixties. Second, I don't know if the model is completely specified. I don't want to comment in detail on VonFurstenberg's work, but I don't think the magnitude you're talking about would be experienced. In addition, I think the point that Don made about the relatively low downpayment requirements that we are experiencing with first-time home buyers is the essential point here.

I think there isn't the need to build up a downpayment for first-time home buyers if they are, in fact, already making downpayments substantially less than this median range.

Senator BROOKE. Would you agree with that, Dr. Kaplan?

Dr. KAPLAN. Yes, Senator. I would add to what Mr. Buckley has said that it's important to realize that it's not just the higher loan to value ratio, or the lower downpayment, that directly translates into the default experience. There are other things operating and, in particular, the income experience of the borrower and the property price appreciation of the property is very relevant. If you have a property, for example, that has appreciated substantially, it's very unlikely that a borrower would readily accept a default situation. So I think that the VonFurstenberg analysis needs to be looked at very carefully before you extrapolate from that to the GPM experience.

Dr. BUCKLEY. That was my point. His analysis was prior to the inflation that we have been experiencing.

Senator BROOKE. Dr. Shalala, at the present time the Congress has before it an administration request for a $1 billion appropriation to

cover losses in FHA insurance funds. My information indicates that the primary losses incurred in the case of single-family homes involved purchases of homes insured under section 221(d)(2) and section 223(f) of the National Housing Act, which require the lowest downpayments of any FHA programs.

I would suggest that you review your experiences under these low downpayment programs in considering programs for reducing the equity that a family has in its home. Both the chairman and I are reluctant to appropriate this $1 billion requested by HUD for what must be regarded as a failure of Federal programs; but beyond money is the tragedy faced by each family unable to keep its own home. I'm extremely reluctant to place first-time home buyers in the position where they are likely to experience the frustration and humiliation of a foreclosure.

So I ask you to do that if you will.

Dr. SHALALA. We will, Senator.

[The following was submitted for the record:]

There are several key differences between the Section 245 GPM program and Sections 221(d)(2) and 223(e) programs that have a critical impact on the risks involved.

The Section 221(d(2) program was designed to assist in the financing of homes for low- and moderate-income families, although it contained no provision for assisting families for meeting the monthly payments. The statute permitted home buyers to purchase homes under this Section with as little as $200 in downpayment—in effect, less than necessary to cover closing costs. In addition, the maximum loan amounts provided in the statute were very low, relegating the program to only the low priced, high risk segment of the market. This program was used extensively in a number of high risk urban areas, most notably among those was Detroit. The Section 223(e) program does not provide for lower downpayments, however, it was used extensively in combination with the Section 221(d)(2) program that does. The Section 223(e) program does not provide the basic insuring authority, but is utilized under insuring authority provided under other Sections of Title II of the National Housing Act. Section 223(e) authorizes the insurance of mortgages on properties in older, declining urban areas under certain circumstances and assigns the obligation to the Special Risk Insurance Fund.

In contrast to these two programs, the Section 245 GPM program is being implemented under the Section 203(b) insuring authority, which has proven to be a sound insurance program. All of the underwriting criteria required under Section 203(b) will apply to the GPM program as well. Further, we do not intend to utilize this program in areas which would require the use of Section 223(e). We intend to require downpayments by borrowers at least equivalent to those required under Section 203(b). The intent of the proposed amendment to Section 245 is to reduce the additional downpayment currently required under the program, which is necessary to accommodate the negative amortization involved in the GPM program, to, or slightly above, the amount that would have been required under Section 203(b) while assuring that the borrower always has at least a 3 percent equity in his home.

The likelihood of the Department needing funding to cover losses under this program is remote, since these loans are being insured under the Mututal Mortgage Insurance Fund which currently has reserves of almost $2 billion.

Senator BROOKE. Dr. Woodworth, in your testimony you stated that the cost of the IHA in the first year is likely to be $6 billion.

Dr. WOODWORTH. I think I added "could be" $6 billion.

Senator BROOKE. I think you did. Your statement said "would be" and then I think you did interpolate "could be."

Dr. WOODWORTH. Right.

Senator Brooke. Witnesses have testified that a taxpayer in the 25-percent tax bracket, saving the maximum of $2,500 will cost the Treasury $625 per household participating. Thus, your $6 billion first-year figure—and I think you said it would then decrease to $5 billion by the second year and remain at that level—implies that nearly 10 million households would participate in the first year of the IHA.

Now the maximum that I have heard suggested was 2 million households participating in the first year. I'd be interested in knowing how you actually arrived at that 10 million participating households and that $6 billion.

Dr. Woodworth. Well, according to HUD estimates, there are 5 to 6 million houses purchased each year, 2 million of them by persons or families that have not bought homes previously. It's likely that there will be a saving period before they acquire the house. In other words, not only do you have the 2 million that are acquiring homes in that year, but you have other families that are saving to buy homes on down through a period of perhaps 10 years on out ahead.

We, therefore, estimate that you may get as many as 12 million taxpayers that will set up these types of accounts. The principal difference in the estimates is due to the assumption as to how many would set up the accounts. We believe that it's not just the number of people that will be buying houses in any year that will set up accounts, but also the large group of people that contemplate buying houses for a period of years on out ahead.

Senator Brooke. What's the basis of 10 million? That seems extreme to me under any circumstances, even if those that are contemplating buying a home are included in your estimates. What yardstick did you use to arrive at 10 million families? I just can't understand that. These are only first home buyers as you know.

Dr. Woodworth. Yes, I'm aware of that. That's all I'm trying to take into account here.

Senator Brooke. And you only have 22 million renters at the present time. That's almost half of the renters.

Dr. Woodworth. Well, even if that's true——

Senator Brooke. And we know about 25 percent of the people are renters probably would not buy homes under any circumstances.

Dr. Woodworth. Well, the only thing I can say in that regard is that we anticipate that a very large volume of renters would set up accounts of this type although I don't believe that anyone can establish the exact number—when you don't have experience with something of this type, it's a very difficult area in which to make estimates one way or the other. I certainly am not insisting that I'm sure of that estimate, but on the other hand, I think it could well be as large as $5 billion or $6 billion.

Senator Brooke. You could have come out with 20 million people that could do it. I mean——

Dr. Shalala. Senator, could I have Dr. Buckley take a cut at trying to explain what numbers we have been looking at? It is a technical argument, but we feel it is important.

Senator Brooke. Do you come out at that figure of 10 million people as well, Dr. Buckley, and if so, I'd like to see the data.

Dr. BUCKLEY. Dr. Rosen and I discussed this last night on the phone. I'd like to list a couple factors that——

Senator BROOKE. I'm sorry. We will take a short recess.

[Recess]

The CHAIRMAN. I want to be sure I understand the administration's position on this legislation as clearly as I can. I realize it's difficult to take a position, especially in the very brief time, Dr. Shalala, you have had a chance to be in the Department—or not even officially in it—but I take it that the Treasury is speaking for the administration in opposing the title that contains the individual housing account. Is that correct?

Dr. WOODWORTH. That's correct. It's been cleared through OMB.

The CHAIRMAN. So the administration's official position is against that particular section of the bill?

Dr. WOODWORTH. That's correct.

The CHAIRMAN. Do you take any position on the rest of the bill?

Dr. WOODWORTH. No.

The CHAIRMAN. Now, Dr. Shalala, can you take a position as of this time? Your statement was a little unclear as to how you come down on either part of this. I take it that you would be guided by the Office of Management and Budget in any event on the individual housing account. Is that correct?

Dr. SHALALA. Yes. It is my understanding, though, that we are in favor of the removal of the 1 percent and of the preemption of State laws section.

The CHAIRMAN. OK. As I indicated, Mr. Woodworth, I thought your statement was a most remarkable statement and I'd like to ask you some questions about it.

In the first place, you argue that the highest benefit for this legislation would be for those of higher incomes and your table demonstrates that.

Dr. WOODWORTH. Yes, I believe that's correct.

The CHAIRMAN. In the second place, you argue that the cost of the program would be about $6 billion in the first year and then something like $5 billion in the years after that.

Dr. WOODWORTH. Yes. Now that's very hard to prove, I must admit, as to the exact size of it, but that's based upon approximately 12 million taxpayers benefiting from the deductions or exclusions.

The CHAIRMAN. Then you—well, as a matter of fact, it would seem to me that anybody who doesn't buy a house and is a taxpayer with any substantial amount of equity would take advantage of this.

Dr. WOODWORTH. I can't understand why they wouldn't. They don't even have to have——

The CHAIRMAN. If you walk into H & R Block, the first question that should be asked is if you own a house, and if not, we've got something for you here.

Dr. WOODWORTH. Yes, and as I point out in the statement, Senator Proxmire, it's possible to do this even if you don't have the savings. You can go out and borrow the money and match the interest that you receive from the account to pay that interest and you get the tax deduction.

The CHAIRMAN. So you not only don't have to save, you don't have to shift the saving you have, but you can borrow money, and as you point out, you can take advantage of this.

Dr. WOODWORTH. You can get a deduction against your income tax for the amount you borrow while not having to include in income the interest payments in the account. So it's a very nice tax shelter and it's difficult to see why anyone who's financially well-off—in the middle brackets or above—wouldn't take advantage of this unless they had already owned a home.

The CHAIRMAN. Now you give the example of somebody who's retiring who could take advantage of this even though they are not buying a house. Let me suggest another alternative. Supposing you're not retiring. Supposing you're a person of considerable wealth and you decide to transfer your wealth after 3 or 4 more years into municipal bonds so you wouldn't be paying taxes—all of your wealth into that, and you're worth several million dollars.

Now if you should do that and know that your tax liability would be otherwise zero, then you could take advantage of this housing account, even though you're not retiring, by just shifting your wealth in that particular way.

Dr. WOODWORTH. That's correct. I agree with you. It doesn't have to be just retirement that could offer such an advantage. You can maneuver your tax rate in various ways and certainly putting part of your income into municipals is one way to do it. There are many other ways; concentrating your deductions in one year, for example, is another possibility.

The CHAIRMAN. Now supposing you want to make sure that you don't have to pay the 10 percent penalty and at the same time you don't really want to buy a house that you would own. Supposing you have an arrangement in which party A is selling to party B a house and you say, well, I'd like to buy a house but only for about 10 minutes. Couldn't you move then into those circumstances and buy the house from party A, sell it to party B, and thereby avoid paying any penalty at all?

Dr. WOODWORTH. I don't believe there's anything in the bill that would prevent that.

The CHAIRMAN. So this would look like a pretty cozy tax shelter. You say it requires lifetime recordkeeping by the taxpayer.

Dr. WOODWORTH. Yes. The reason I say that is the following: as Senator Brooke said, they plan that you can have only one individual housing account in a lifetime. Therefore there needs to be a record kept as to whether an individual has ever used this account or not previously; that's a very difficult kind of account to keep for tax purposes.

It's against the party's own interest to keep that account, to keep a record of having previously purchased a house, so that the Internal Revenue Service is almost put in the position of proving a negative in that case and it's very difficult.

The CHAIRMAN. You say that a new tax form would be required. Why is that?

Dr. WOODWORTH. Well, it would be a new schedule. It would be a new schedule on the tax form because the computation of credit and

the carrying over of that item to determine how much had previously been taken. You can take the deduction up to $10,000, so that you would have to determine what the cumulative amount was. I haven't worked out the schedule, but clearly it would require an additional schedule with the return.

The CHAIRMAN. What proportion of our taxpayers use the standard deduction roughly?

Dr. WOODWORTH. It's about 69 percent, and if the bill before the Senate should be passed, it should be up to about 75 percent.

The CHAIRMAN. Well, now, would you be able to use the standard deduction and take advantage of this tax break?

Dr. WOODWORTH. Yes; I'm told it is above the line, so that you could use it, yes.

The CHAIRMAN. Dr. Kaplan, I want to commend you for the amount of basic research and analysis on home affordability contained in your testimony and the fine job the Home Loan Bank Board has done. I take it this is a very long study you have made, not an impulsive study you have made in the last few days or few weeks even.

In view of the time constraints, we won't go into depth on most of this, but we will ask questions for the record and expect to invite you back for further hearings on this subject perhaps later this year.

Dr. Kaplan, without taking a position against GPM's, let me list for you some of the criticisms we've heard of it and ask you for your overall reaction.

First: Reduced flow of mortgage credit, of course, from the lender's standpoint is a very serious problem. Second: Increased risk of defaults because, of course, the plan assumes increasing borrower income that may not develop and the equity is reduced lower than it otherwise would be. Third: Greater lender selectivity among borrowers by income, family, type, and neighborhood means that you would select borrowers that had higher incomes by and large. Fourth, higher total costs: It's been estimated at 15 percent. Higher interest charge, according to the testimony of Mr. Smith who testified yesterday representing the savings and loans; higher origination fees; higher servicing fees; higher insurance premiums; higher downpayments; difficulty in resale in early years; more customer relations problems; and built-in inflation of interest rates.

That's a kind of imposing list. Would you like to summarize for us the chief benefits which outweigh those liabilities?

Dr. KAPLAN. Yes, Senator, I will certainly try. I think the chief benefit overall is that the GPM is going to provide an increase in availability of mortgage credit for certain groups—I think that's the underlying premise that we're looking at.

Let me now go through each of the specific points you raised.

The CHAIRMAN. Before you do that, because I asked for the benefits primarily in answer to this question, the question then is, whether or not the groups that could take advantage of this are groups who would otherwise not be able to buy a house and whether the group under the circumstances would be a very large proportion of the population, sufficient to warrant all of the liabilities that Dr. Woodworth and you have indicated?

Dr. Kaplan. Let me amplify on that, Senator. Yesterday, in Dr. Smith's testimony, he showed that although they have just I believe, approximately 10 applications in process on the GPM, several of those borrowers would otherwise have not qualified on an income eligibility basis for a standard level payment mortgage.

Now, admittedly, that's just too small an amount of evidence on which to form a judgment, but that's the kind of response that we would expect with this instrument. Certainly, however, we are going to have to wait until some experience develops to be conclusive on it.

In my testimony we have provided some tables that we have been developing as part of our longer term research study that speaks to the demographic situation and what the numbers suggest is that, indeed, there are a sizable number of families that have experienced and we would expect to continue to experience the kind of income increases that one would need to accommodate the rising payments schedule with the GPM. So we really do believe that the evidence at this point is that this instrument will provide more credit to a group that otherwise would not have been eligible to receive the credit.

The Chairman. Secretary Shalala, in your statement you say that you hope private mortgage insurers will look to the expanded FHA programs as a source of actuarial information. Will FHA break in new ground for the conventional market as it has done in the past—well, does this mean you would oppose the GPM being expanded to conventional loans until the expanded FHA program has had time to compile a record?

Dr. Shalala. I'm sorry, Senator. I don't understand your question.

The Chairman. The question is whether you want to hold off on conventional and use FHA now?

Dr. Buckley. As long as private insurers are willing to undertake this, we don't object.

The Chairman. So you would want to go right ahead with the conventional?

Dr. Shalala. Yes; I did want to comment, Senator, on the earlier question on whether we have any information about the borrowers that are using GPM's. We have information which I understand has been provided to this committee. Homebuyers using GPM's are younger. They have lower average income than those that are using the 203(b) mortgages. So the fragmented information we do have indicates that it's a different kind of borrower that's using this instrument, but it's very tentative and we hope to have more information in a few months.

The Chairman. Very good. I note in Dr. Shalala's testimony it cites the current tax deductions for homeowners as amounting to $5 or $6 billion a year, whereas the testimony we will hear later from Mr. Mundel shows the figure is nearly $11 billion.

You are perhaps the foremost tax expert in the United States, Dr. Woodworth. Could you enlighten us on what the actual cost is for the current deductions?

Dr. Buckley. Our figure is just interest deductions, Senator.

The Chairman. OK, I see.

Dr. SHALALA. Before Senator Brooke left we were going to go through the numbers and explain our projections. I don't know whether you want to wait until he comes back or not.

Dr. WOODWORTH. On the cost for the current deductions we would have to add up all of the tax expenditures. I don't have that record with me, but I can supply it.

[Material supplied for the record:]

TAX EXPENDITURE ESTIMATES—1977

Deductability of mortgage interest on owner-occupied homes	$4.7
Deductability of property taxes on owner-occupied homes	3.8
Deferral of capital gain on home sales	.9

The CHAIRMAN. Both of you agree this would be roughly the equivalent, or close to it, of the benefit we get now from being able to deduct our mortgage interest from income on income tax which is the major benefit for homeowners at the present time.

Dr. WOODWORTH. That is one of the main ones. You have, of course, the deduction of the property taxes on the home, which is another major item. And you also have the fact that the homeowner excludes from tax the value of the services provided by the home that he lives in.

So there are a number of appreciable tax advantages. But I would certainly agree as to the size of this cost, that it is probably about the same as the interest deduction.

The CHAIRMAN. Dr. Kaplan, FNMA has agreed to buy the experimental GPM's with a yield differential to compensate for their lower cash flow and higher risk.

Does this mean conventional GPM's would likely carry a higher interest rate, too?

Dr. KAPLAN. Yes, Senator, I believe it does. The discount that FNMA is anticipating using at this point in terms of creating a secondary mortgage market runs from 10 to 30 basis points, depending on the specific GPM plan.

There is a cash flow timing difference on these instruments, which is one of the points you read off on your list. But it is not a very significant difference in terms of the amount of mortgage credit available and the impact in that direction.

The CHAIRMAN. Would it be significant if, for example, this thing really went in a big way, 60 or 70 percent of your mortgages were in this form? Would that have a significant adverse cash flow effect on an S & L, for instance?

Dr. KAPLAN. I don't believe so, Senator. We will develop some numbers for you on this. But based on a preliminary look, it would appear to us that the cash flow effect of the lower payments in the early years is not as large as I think some of the witnesses yesterday suggested.

In fact, I think on each of the points that you listed, the challenges to the instrument can be shown not to be that substantial.

The CHAIRMAN. What do you think of the secondary marketability of the GPM?

Dr. KAPLAN. I think that as long as it is developed as a uniform instrument, and certainly if the private mortgage insurance companies are interested in providing coverage for this, a secondary market can develop and will embrace this instrument.

The caution I would stress is that we don't know yet what kind of an insurance charge the private insurance companies are going to want to assess because we don't have any experience with GPMs.

That is why we support the proposal in the bill, so that this instrument can be placed into the market and we can get some experience, which will provide a basis for the conventional market to follow suit.

The CHAIRMAN. Secretary Shalala, in your statement you say that while this instrument would be designed in a way for people who are upwardly mobile, it wouldn't be confined to that, with an inflation tilt there might be a tendency for people who are not upwardly mobile also to be able to take advantage of it.

In view of the uncertainty about future inflation and the fact that lenders will probably be reluctant to offer GPM's because of the cash flow problem, don't you think lenders will limit these loans to people who seem to be upwardly mobile, rather than the rank and file person, a blue collar worker, for example, who is probably not going to have much increase in income as time goes on, at least increase in real income?

Dr. SHALALA. I just don't think we have the evidence yet, Senator. I don't think we can speak for the lenders yet on the subject. Fragmentary evidence indicates that relatively lower income younger homeowners are getting an opportunity to use GPM's. So I would hesitate to say more than that.

The CHAIRMAN. Unfortunately I have to run over to vote, and I will be back as fast as I can. Senator Brooke is back.

Senator BROOKE [presiding]. Dr. Woodworth, in your testimony you made two further assumptions in calculating the cost of the IHA, which I seriously question.

First, you assume that every first-time home buyer will use the program to the full $2,500 a year.

Dr. WOODWORTH. Well, I would like to be clear on this. We do not think that all users will exhaust their lifetime maximum for contributions or that they will use the maximum deduction. But in estimating the total cost, this fact is partially offset by the fact that you have the excludable interest, which is an offset in the other direction.

Senator BROOKE. I don't know to whom you all have been talking, but the people I have talked to have indicated that many families do not have enough income to save more than $1,000 per year.

Why did you assume that every family who established an IHA would save $2,500 a year?

Dr. WOODWORTH. As I point out in my statement, it is not necessary that you save this in order to take advantage of it. You can put existing savings into an account of this type, just as well as new savings.

And in addition, as I also pointed out in the statement, it is possible to gain the advantage of this by the use of borrowed funds.

So there are different ways of taking advantage of the deduction.

Senator BROOKE. That would apply also to the IRA as well as the IHA, wouldn't it? You have tried to make some distinction between the two accounts.

Dr. WOODWORTH. Yes, in IRA it is possible to borrow. But there generally you can't take the money out of the account until you reach age 59 and a half.

Senator BROOKE. But you couldn't withdraw this money until you bought a home.

Dr. WOODWORTH. Well, that must occur within 10 years. Moreover, you can buy a home 1 day, and as Senator Proxmire pointed out, you can turn it over presumably the next day. So that presumably isn't too difficult a provision.

Senator BROOKE. Do you really think that a person would pay real estate agent commissions, at about 10 percent, lawyers closing costs, and other substantial prepayments and costs just for this benefit?

Do you really think people will go through all this to get this little savings? Let's talk about reality now.

Dr. WOODWORTH. I certainly do believe it will happen. I have seen the way some individuals use tax shelters and I am convinced they won't have to pay real estate commissions in this case.

Senator BROOKE. Is IRA a tax shelter?

Dr. WOODWORTH. Yes.

Senator BROOKE. Have they used that the same way?

Dr. WOODWORTH. Yes, to some extent.

Senator BROOKE. To what extent? What have you done to change it?

Dr. WOODWORTH. Well, it is still quite new, so that we are still experimenting with it in that regard. The problem with the——

Senator BROOKE. I have heard no criticism of it.

Dr. WOODWORTH. The difference in IRA is the fact that you already have employee pension plans in which there is tax deferral, and the IRA and also the Keogh-type plans are designed to give equality to those who don't have that opportunity.

So that the IRA really is a movement towards tax equity in the sense of giving individuals not covered by qualified pension plans an opportunity to get equal tax treatment.

So that at least I view the IRA as an equalizing factor, rather than an unequalizing factor, which I think the individual housing account would be.

Senator BROOKE. Do you think the first-time buying of a home has any social merit at all?

Dr. WOODWORTH. Of course it does.

Senator BROOKE. Don't you think this has as much social merit as an IRA has?

Dr. WOODWORTH. I think that the social merit of this can better be achieved through loan guarantees than through tax reductions.

Senator BROOKE. We have talked about the losses on loan guarantees, haven't we? It cost the taxpayers a lot of money. We also looked at the shallow subsidies, which would cost the taxpayers even more money.

Isn't this the least expensive manner in which we can realize that social merit?

Dr. WOODWORTH. No, sir. We believe it is much cheaper the other way.

Senator BROOKE. Shallow subsidies?

Dr. WOODWORTH. I am not saying necessarily shallow subsidies. We are saying that loan guarantees are a much cheaper way, even with substantial defaults, than a system of this type, which could result in a revenue loss of up to $5 or $6 billion.

Senator BROOKE. I am not going to accept that $5 or $6 billion, because you haven't given any data to support it, and neither has HUD. You said it could be up to $6 billion. Do you have some data?

Dr. SHALALA. Yes.

Senator BROOKE. Will you supply that for the record?

Dr. SHALALA. Yes we will, sir.

Senator BROOKE. Are you prepared to say this program will cost $6 billion?

Dr. BUCKLEY. In that neighborhood, yes, sir. In the neighborhood of $6 billion per year.

Senator BROOKE. Based upon what? How many families? Are you using the 10 million families that Dr. Woodworth used?

Dr. BUCKLEY. Senator, I would like to point out three groups of families that Dr. Rosen didn't consider.

Every year, if you use 1975 evidence, 1¼ million families changed status from homeownership to renter. If we keep the same proportion of homeowners and renters, they have to be replaced by new home buyers, first-time home buyers. That amounts to 12 million additional families over the next decade.

In addition, Dr. Rosen's projections are with respect to 12 million new households over the next decade.

If the same proposition is maintained as at present, that is an additional 8 million families.

Also there are families that will be buying after the decade is over, families will be buying in 1987, will start accounts in 1984, similarly in 1988 they will be starting accounts in 1985. That adds another 9 million to the total.

You are talking in the neighborhood of 20 million families. I realize it is a technical argument, and I would rather submit it for the record, but I think even if you accept Dr. Rosen's figure that only 60 percent of these families would participate, you are still talking about 12 million families.

If you took Dr. Rosen's average tax loss per family, that still comes to about $50 billion, divided by 10, gives you $5 billion per year.

I would rather place this in the record.

Senator BROOKE. I wish you would. You are just throwing out wild figures at the present time.

Dr. SHALALA. Senator, we will put a detailed accounting of our numbers into the record.

There is a difference of opinion in how many families will participate.

[The following was submitted for the record:]

An Estimate of the Tax Loss Generated by the Individual Housing Account (IHA) Proposal (S.664)

In order to estimate the tax expenditures caused by enactment of S.664 a listing of the households eligible for the tax deduction must first be made. These include: (1) households coming into the housing market for the first time during the next decade; (2) households who are currently renters and will become first time homebuyers during the next decade; and (3) households who begin accounts during the next decade in anticipation of purchases in the years immediately following the next decade, i.e., 1987, 1988 etc.

1. Estimates of the change in households vary widely and range from 12 to 17 million. If we assume that the same proportion of these new households become homeowners as presently characterizes residential tenure choice, then 65 percent of these new households, or 7.8 to 11 million will be first time homebuyers.

2. Similarly, if we assume that already existing households maintain the present owner-renter ratio then owners changing to renters must be replaced by current renters. The Annual Housing Survey indicates that in 1975 1.25 million homeowners became renters. It is, of course, dangerous to extrapolate from one observation, but in both 1973 and 1974 almost 1 million owners became renters. An additional mitigating factor arises from the fact that some unknown proportion of the renters becoming homeowners previously owned homes and so not be eligible for the subsidy. To take these factors into account, we assume that 800,000 previously owner-occupied homes will be purchased each year by first time homebuyers who previously rented—8 million over the decade.

Taken together these two groups suggest that in the next decade at least 15.8 to 19 million families will in principle be eligible for the subsidy. In other words, even if the subsidy does not increase the proportion of households owning homes, roughly 1.6 to 1.9 million home purchases per year will qualify for IHA assistance.

3. Finally, if we assume that those who purchase in 1987 begin their accounts three years earlier, then in 1984 1.6 to 1.9 million additional IHA accounts will be opened. Another 1.6 to 1.9 million will be added in 1985 and again 1986 for purchases in 1988 and 1989. Because only a portion of the tax loss associated with these accounts will be realized in the next decade this source adds a tax loss equivalent to 3.2 to 3.7 million average deductions. (The accounts started in 1986 will only realize two thirds of the tax loss in this decade and those in 1986 will realize only 1/3 of the loss. Therefore: 1.6 + 1.07 + .53 = 3.2.)

Adding this last group to the previous two sums to 19 to 22.7 million units eligible for the average deduction, if this subsidy does not increase the proportion of homeowners. Now, a determination of the average deduction must be made.

Professor Rosen's estimate of $6 billion in costs for 2.5 million participating families (p. 11 of his testimony) suggests that the average loss will be about $2,400 per account. This seems somewhat conservative if his projections of inflation are accepted (because a 7 percent inflation rate would increase the average down payments, marginal tax brackets and the interest-income exempted from taxation), but it does serve as a helpful benchmark. Multiplying the number of eligible families by the average tax loss yields a tax loss of $45.6 to $55.5 billion over the next decade. These figures do assume that all eligible families participate, an assumption with which reasonable people could disagree (and one which we will discuss below), but they should not be taken as upper bound estimates of the potential costs. They do not take into account any behavioral response to the deduction. If, for example, the program caused the proportion of homeowners to increase by two percent over present levels, and additional 1.8 million households would be eligible at a cost of $4.3 billion in tax expenditures. In addition, no estimate was made of the use of IHAs for non-housing purposes. Any such estimates would be purely conjectural, but they could be substantial, especially since the current penalties in S. 664 do not provide a strong deterrent to such misuse. For instance, if only one account in twenty is not used for housing purchase, tax expenditures would increase by another $2 to 3 billion over the decade.

As far as the assumption that all elgible households participate—it appears reasonable to us for two reasons:

1. The program provides such a steep subsidy that it would pay homebuyers to borrow the funds for the account even if they had to pay the 18 percent finance charges on some consumer credit. Clearly IHAs provide a strong incentive to open accounts.

2. If such a program were enacted and less than full participation was achieved, it is likely that those most in need of assistance would not be receiving it. Common sense suggests that income levels are positively correlated with the frequency with which individuals take advantage of available opportunities. Thus, lower levels of participation would imply that the subsidy would be going, in large part, to those first time homebuyers who need it least.

Nevertheless, despite these arguments, the basic fact remains—no one can accurately predict how many of the eligible households will take advantage of the program. What can be predicted, with a very rough degree of accuracy, is the number of families eligible for participation. If, for the sake of argument, we assume that only, say, 60 percent of those eligible participate, tax losses are not likely to go below 60 percent of the aforementioned estimate, or $3 billion per year over the next decade. If participation rates drop below 60 percent it seems likely that a large portion of the targeted group—young middle income families—would not be served by the subsidy. Thus, $3 billion per year can be taken as a conservative estimate of the annual tax loss, and if the program experiences higher participation rates, losses can be expected to go as high as $6 billion per year.

Senator BROOKE. I don't think anyone knows. Do you know actually how many families will participate?

Dr. BUCKLEY. That is right, no one knows that. But you have to at least account for some of the families who are now renters that will become homeowners.

Dr. Rosen just considered the new household formations. He did not consider those owners going back to renter status. We are not talking about a change in the proportion of renters and owners.

Senator BROOKE. Would you submit it for the record. There are some serious questions here, and I would like to see the data.

Dr. Woodworth, you assumed that all first-time buyers would establish IHAs, and utilize them to the full extent before purchasing a home.

That is the basis of your estimate as well, is that correct? And this presumes that families who could buy a home right now will defer their purchase to take full advantage of the IHA. To me this really seems unrealistic. If a family can buy a home now, with the projected increase in costs of that home, projected inflation, you are saying that that family will not buy that home, even though they could afford to, in order to take advantage of this IHA.

As I said, with prices rising at the rate of between 5 and 10 percent a year, what sense does it make for a family who can afford to buy a house to defer the purchase to take advantage of the tax incentive that amounts to no more than $400 to $1,000 per year? It might happen in a few isolated cases. But it would be a loss to those families rather than a gain.

Dr. WOODWORTH. Of course I didn't say that everyone would not buy a house. But on establishment of the program potential home buyers who are on the margin of a decision as whether to buy or rent will be given an incentive to delay their purchases. Not all will delay but the movement would be in that direction. And I think it is clear

that individual housing account would tend to present an alternative to people; they would have an incentive not to buy a house now, that the individual housing account would tend to present an alterna- that a significant tax shelter puts more weight on the side of not burdening oneself with the obligation of paying for a house.

Senator BROOKE. Well, you assume that everyone is looking for a tax shelter, because you have been in the business a long time, and I can understand your orientation.

I assume that people want to buy homes. If they have the money to buy a house, and everyone is telling them that prices are going up each year, I don't see why those families are going to look at this "tax shelter" of $400 to $1,000, and decide to wait 4 years to buy a home, and be exposed to higher inflation and higher costs. It just doesn't seem to me that that will be the trend.

Dr. WOODWORTH. To me another point to consider is the fact that there could be many people who will come into this not with the intent of obtaining a home and keeping it for any period of time, but with the intent of taking advantage of the tax shelter.

I can't see any reason, when the tax shelter is there—without even saving on their part to obtain it—why individuals wouldn't take advantage of it to the maximum extent possible.

Senator BROOKE. You are talking about tax fraud?

Dr. WOODWORTH. No, I am not. Not tax cheaters. Those who are using the law as it is on the books.

Senator BROOKE. We are not passing this law to create a tax shelter. The purpose of the law is to enable first-time home buyers to buy a home. We think it is a very laudable purpose. I think you would agree with that.

Dr. WOODWORTH. I am not questioning the motive.

Senator BROOKE. We are trying to find out how can the Federal Government give some assistance, primarily to young families to buy their first home.

Now, you are either going to do it through a shallow subsidy, where the Government would pay the difference between the prevailing interest rate and the lower interest rate, or guaranteed loans, where admittedly we have had a high loss, and the program hasn't done the job so far. Or we will give some sort of tax benefit. That is why I decided to offer the tax benefit as the only viable alternative to enable young people to buy that first home.

I just don't believe that you are going to find that people, rather than buying a home, are going to be out looking for ways of cheating the Government by using funds for the purchase of a home, and sell it the next day.

In my opinion, as a former state attorney general, that is a fraud on the Government. You may say well it is a legitimate act on the part of that home buyer. But that certainly is not the purpose and intent of this law.

Dr. WOODWORTH. I am sure it is not the intent. But it seems to me there is nothing to stop people from using it, and there is nothing illegal about their using it.

Senator BROOKE. We could write in a certain period that the home has to be held.

Dr. WOODWORTH. How long a period?

Senator BROOKE. I don't know. Perhaps a year or two years, I don't know. But we will consider amending the law to see that the person has to hold the home for a reasonable period of time.

That kind of provision would take care of the person you talk about—I think that person would be committing a fraud, but you can say they are just taking advantage of a loophole in the law.

I know there are some cases, as you say, where a person might legitimately have a change of job after they buy the house, or they might have to sell it for other reasons. I wouldn't want to hold them to, say, a 10-year period.

Dr. WOODWORTH. That is one of the problems in trying to come up with a limitation.

Senator BROOKE. Yes, that is a problem. But I think a reasonable limitation would take care of it, so it wouldn't be profitable for some people to do what you suggest could be done.

I agree with you that some people could circumvent the intent of the law. I don't believe it would be done in any large measure, because I earnestly believe that there are many young families in this country, who have not been able to buy a home. And believe that the reasons are twofold: One, down payments, and the other, of course, high initial monthly mortgage payments.

In your statement, you say that a taxpayer would be given a strong inducement to delay the purchase of a house until all tax benefits of a IHA have been received. You suggest home purchases could be delayed for 5 to 10 years.

To do this—and this is a followup on what I already said to you—a potential home buyer would have to forgo between $3,000 and $5,000 per year or more in appreciation.

Furthermore, they would forgo the mortgage interest tax deduction and local property tax deduction, which would amount to substantially more than the tax advantage of an IHA.

If you are right, the IHA would be a great moneymaker for the Treasury. You must agree your assumptions would lead to rather bizarre results.

What I am trying to say in essence is that I don't believe it would be profitable, frankly, for home buyers to take advantage of this for tax shelters or tax breaks as you have indicated. And I think the Treasury would actually end up saving money under it.

I ask you to look at that argument very seriously.

Dr. WOODWORTH. We will be glad to. It seems to me, however, that there is nothing to stop them from having other investments, if they can afford it, for instance, in real estate, during the same period of time that they are setting up such an account. They could then get all of the advantages of appreciation and value you are referring to.

Senator BROOKE. It couldn't be a home, you understand that. It could be a store, perhaps because the legislation provides it can only be used for a residence.

Dr. WOODWORTH. I think it could be a rental residence.

Senator BROOKE. Oh, no.

Dr. WOODWORTH. One they did not live in and simply rented out to someone else.

Senator BROOKE. No, sir.

Dr. WOODWORTH. It could be ownership in an apartment development.

Senator BROOKE. I had no intention that it could be any residence at all, apartment building or house that they buy to rent out. If they can buy a house to rent out, I would agree with you, Dr. Woodworth, they could live in that house, or they could sell that house and buy a house to live in. You can't have the person using this plan to save money and get a tax advantage by buying a home at the same time they had other rental real estate.

I can see a case where—I don't know whether we want to allow this or not—a person might own a store or commercial property. But generally the person with a store would have income which would be beyond the income limits that we will establish for the home purchaser.

Dr. WOODWORTH. I think you are referring to provisions that aren't in the bill yet, but which you are contemplating putting into the bill.

Senator BROOKE. Some are and some are contemplated; yes.

Dr. WOODWORTH. Therefore, not knowing exactly what those provisions are, I can't really affirmatively comment on them.

Senator BROOKE. We will make it clear it is the first home, and if there is any question about that, we will clearly spell it out.

Dr. WOODWORTH. When I said first home, I assumed that meant they could have other rental property without any question being raised.

Senator BROOKE. That might have been a proper assumption, but that is something we intend to make clear. And we would like to close all of the loopholes against—taking unfair advantage of the purpose of this act.

Dr. WOODWORTH. We would be glad to review that with you.

Senator BROOKE. We will include a limitation on income as well in the bill. But it will be a realistic income limitation, it won't be $10,000 or $12,000, because then we don't serve a lot of the people we hope to serve.

Very clearly, Dr. Woodworth, had you not come here, I would have come down to Treasury talking to you about this. We really are concerned about the growing number of young people who are unable to buy a home. We are trying to find ways in which to enable them to do so.

I know, Dr. Kaplan said that some families are using their money for vacations and other purposes. There may be some truth to that, I am sure. But on the other hand, with the housing market such as it is today, the cost of the home, whether you use a $48,000 figure or $45,000 figure—you don't have to go to $70,000 or $90,000—the cost of housing is still beyond the reach of young families today, particularly when you add high fuel costs, high utility bills, high property taxes, high land costs, and high construction costs.

They talk about $25,000 homes. I think we have a very serious problem in the country. And we have to resolve it. So I would like to believe we are allies in this cause, and I would like to believe HUD is an ally in our effort to accomplish our objective at the least possible cost to the taxpayer.

The chairman is back, and I am sure my 10 minutes must be up. Thank you very much.

The CHAIRMAN [presiding]. Dr. Woodworth, isn't the real trouble with this, the reason why it would cost a great deal more than the Treasury could get out of it because everybody buys a first home, virtually everybody could be expected to take advantage of this, whether we had this in effect or not?

In other words, if you are going to have 2 million housing starts a year, of which maybe a million, to take a simple number, are people buying a first home, you could expect most of those, maybe 800,000 or 900,000, whatever, to take advantage of this one way or another. Maybe only for a year, and maybe only make the first $2,500 payment. Others would postpone buying the homes, as you say.

But the point is people are going to buy homes anyway, without this legislation, would be able to reduce the tax burden they would otherwise have, and therefore the revenues the Treasury would receive.

There may be some additionl ones, we don't know how much that would be. It would have to be a considerable amount to provide the economic stimulus from which the Treasury would derive more in taxes.

Dr. WOODWORTH. I agree. I think it is clear that those who would buy homes in any event will certainly use such an account for some period of time, and I have also suggested that I think many who don't plan to be homeowners for an extended period of time, or perhaps didn't previously plan to be homeowners at all, will use the account in order to obtain the tax saving.

We have been through a period in which the search for tax shelters has been very strong. The Congress has seen fit to close down on many of those tax shelters. It seems to me that you would find that there would be as much money as possible diverted into tax shelters of this type if they were available in the law.

The CHAIRMAN. Secretary Shalala, in your statement you take issue with S. 664, with the provision requiring a minimum 10-percent downpayment on FHA GPM homes, saying that the key factors in default patterns is not how much equity the homeowner has, but how quickly he is accumulating additional equity.

I am sure that the rate of equity expansion is very important. I would think it would also be important to insure each homeowner has enough invested in the home so that he wouldn't be willing to lose it.

In other words, if you are not acquiring equity very fast, if you have a significant equity, you wouldn't walk away from it.

Dr. BUCKLEY. Senator, with the proposed 10-percent downpayment requirement, you could graduate the payments at rates approaching 12 percent and still be consistent with the regulations, as long as you keep that 97-percent maximum loan-to-value ratio. The point is that the legislation must consider both the downpayment and the maximum loan-to-value ratio. Of course if you are going to keep the current rate of graduation, and the lower downpayment requirement, it will be somewhat more risky with the current rates of graduation and a 10 percent downpayment, but that extra risk will help to provide homeownership for the first-time home buyers.

The CHAIRMAN. Don't you have to pay for that risk one way or the other? Isn't a lender going to argue if you are going to have greater risk, he wants a higher interest rate or some other kind of concession?

Dr. BUCKLEY. The insurance premium is a little higher. It is one-half of 1 percent of the outstanding balance. Since you are borrowing more, you are paying a little higher insurance premium.

The CHAIRMAN. Both you and Dr. Woodworth, as I understand it, rely on insurance as an alternative here. I wasn't here, but I understand Senator Brooke pointed out the insurance programs have been expensive, they haven't worked very well.

Why do you think we can have an insurance program now that will do the job, in view of our unfortunate experience in recent years with FHA?

Dr. BUCKLEY. Senator, we think for the most part the 203 program, which has the same requirements as the 245, has worked fairly effectively: I think most of your high-default experience is with low-downpayment subsidy programs. In addition, I think most of the analysis of the rate at which default increases, for a given change in equity are dated from the early 1960's, a period in which equity appreciated less rapidly than in recent years.

The CHAIRMAN. How big are those programs? Can you document that the loss has been in the subsidy program?

Dr. BUCKLEY. Senator Brooke has raised this issue and we will submit it for the record.

The CHAIRMAN. All right. Mr. Kaplan—I take it you will give us further documentation for the record?

Dr. BUCKLEY. Yes.

The CHAIRMAN. Mr. Kaplan, you say unless there is a Federal insurance of GPM, we can't develop experience with it, because lenders and private insurers are reluctant.

We are also told that FHA insurance is a very small program at this time. If this is the case, how long do you think it will take to get a reasonable test?

Dr. KAPLAN. I think it will take a number of years before we really can draw firm conclusions.

The CHAIRMAN. See, the problem right now, as Senator Brooke pointed out so well, this is the time when we need housing for young people, young families. They just aren't able to get it, they are priced out, every study we have indicates that. We hate to wait years for a study before we can move ahead with the program.

Dr. KAPLAN. I don't think anybody is suggesting we wait. My own preference would be to recommend that federally chartered lenders be allowed to start offering these instruments immediately. The real question in my mind is how long it is going to take until the lender community and the private insurance community feel comfortable determining what kind of premium structure they are going to charge.

The CHAIRMAN. That is what Senator Brooke is trying to do. I am reluctant, as you noticed in my question, about the independent housing accounts. But at least it is a proposal that does provide some degree of equity. I think it is ingenious. As I say, I don't buy it, but I think it is better than nothing—no, I don't know if it is better than

nothing or not. Maybe not. But it is something. You ought to have some alternative to it.

Dr. KAPLAN. I think the key points I have been trying to stress in my statement is that the more serious problem today is with meeting monthly payments as opposed to the downpayment. I don't mean to minimize that——

The CHAIRMAN. That is right. That is a more serious problem—I hate to interrupt you—certainly for the home buyer, I agree with that. But for the lender, having that 10-percent downpayment represents a solid clear element of protection; doesn't it?

Dr. KAPLAN. It does, except that it takes the flexibility of making business decisions away from the lender and the insurance company. It is not clear what the tradeoff between downpayment and insurance premiums is going to be. As HUD has just indicated, there is capacity in the proposal to allow either lower downpayments with this proposal, or alternatively, higher rates of graduation.

Our recommendation is that you allow the flexibility for lenders, borrowers, and insurance companies to determine what combination of downpayment and graduation rate make the most sense in terms of determining how that will be priced in terms of the insurance cost.

The CHAIRMAN. Secretary Shalala, you make a proper point that you have a problem here with some of the State provisions which now make the GPM unworkable. I think my State may be one of them.

At any rate, do you know how many States have that problem? And have you approached them to make sure that HUD's proposal would not be acceptable?

I was concerned when I read your statement with the fact that the States put these laws into effect for some reason, they don't like loan sharking, they want to be sure that there is protection for the borrower. You seem to be very sure that this would eliminate the State laws in this particular case without any real risk or danger to the consumer.

Dr. SHALALA. There are 31 States and the District of Columbia, Puerto Rico, and the Virgin Islands, which now have these provisions.

The CHAIRMAN. So most States have them.

Dr. SHALALA. Yes. Let me ask a representative from FHA to comment on this.

The CHAIRMAN. All right. Will you introduce yourself for the record, please?

Mr. FOSTER. Chet Foster.

The CHAIRMAN. What is your title?

Mr. FOSTER. Director of the Financial and Economic Analysis Division for the Assistant Secretary for Housing.

Our regular 203 program has a provision that prohibits the payment of interest on a delinquent payment, exactly like the State laws do. I think in no case were the State laws designed to prohibit the freely contracted for negative amortization, and I think it is mostly a kind of a technical problem with the law.

In some cases, according to the information we are getting from various States, it may very well be nitpicking on the part of lawyers, title lawyers, and title insurance companies even perhaps.

The CHAIRMAN. Give us as much of that for the record as you can. It is obviously a detailed problem we should look into.

Finally, Dr. Woodworth, your statement refers to President Carter's desire to simplify the tax laws. I am sure almost all Americans would applaud that. The reason I say almost all, is perhaps lawyers and accountants might lose a little business.

Can you give us an indication of whether you anticipate the administration to look favorably on any new tax incentives this year beyond the basic administration proposal for economic stimulus?

Would you advise policymakers to look for nontax approaches to solving the problems?

Dr. WOODWORTH. I certainly am not aware of any intent on the part of the Carter administration to advocate tax incentives, except possibly in the area of energy.

[The following was submitted for the record:]

Many States have laws that prohibit the charging of interest on interest. The intent of these laws was to protect the consumer from the compounding of interest on delinquent loans. At borrowing rates for many consumer loans, a debt can easily double in less than four years if no payments are made.

Under the Section 245 Graduated Payment Mortgage (GPM) program, the mortgage payments on the loan in the early years of the mortgage are, in virtually all cases, not sufficient to cover the full amount of interest due on the loan. The interest shortfall is capitalized or added to the outstanding principal obligation (negative amortization) and the outstanding principal balance will increase for a time. In order to maintain the contract rate, interest must be computed on the entire outstanding balance including the capitalized interest. To do otherwise, would mean that the loan had a variable interest rate and would be in violation of Section 245 of the statute.

Under the GPM program and other home mortgage insurance programs, HUD regulations prohibit the charging of interest on delinquent payments—in effect, similar to the intent of the many State laws. However, such laws can be interpreted to prohibit the GPM loans. Title insurance companies have notified us that in the States and other jurisdictions listed, title policies for properties financed under the GPM program would have to include an exception to the policy with respect to the capitalized interest. In those cases, the lender may not be able to deliver a clear title in the event of an insurance claim—in effect, precluding the use of this program in most of the listed States.

STATES AND OTHER JURISDICTIONS WHERE STATE LAW MAY PROHIBIT THE USE OF THE GRADUATED PAYMENT MORTGAGE PROGRAM

Alaska	Nevada
Arkansas	New Jersey
Colorado	New Mexico
Connecticut	New York
Delaware	North Carolina
District of Columbia	North Dakota
Florida	Ohio
Georgia	Oregon
Hawaii	Rhode Island
Illinois	South Dakota
Indiana	Utah
Louisiana	Vermont
Maryland	Virginia
Michigan	West Virginia
Minnesota	Wyoming
Missouri	Puerto Rico
Nebraska	Virgin Islands

The CHAIRMAN. You feel it is better to look to other means?

Dr. WOODWORTH. I think so, yes.

The CHAIRMAN. Senator Brooke.

Senator BROOKE. Mr. Mundel and Mr. Schechter, who will testify after this panel concludes, are concerned that the increased payments under GPM with rising high unemployment could produce an unusually high default rate. What is your view?

Dr. KAPLAN. I don't feel at this time that there is any evidence that would suggest that we would have an unusually high default rate.

Unemployment is a problem that faces all borrowers, whether they be borrowers, whether they be borrowers using a GPM or a standard level mortgage. The history of the lender community is that forbearance has been a traditional practice where temporary unemployment in particular has been the source of the problem in meeting payments.

So my feeling is that this would not create an undue risk.

I should stress again that one of the caveats that I think all of the panel members have made is that this instrument is not an instrument that would be well-advised for an individual where increases in nominal income are not anticipated.

If you have a borrower who anticipates essentially level income in spite of general inflation in incomes, then this instrument would be ill-advised for this individual and you would have a default problem notwithstanding unemployment.

So it is a question of tailoring the mortgage instrument to better suit the particular financial situation of a particular type of borrower.

Senator BROOKE. Now you indicated there would likely be a very significant number of households that would benefit by the availability of the GPM. Could you estimate the likely demand for the GPM over the next 5 to 10 years and what factors are likely to influence that demand, such as the rate of inflation, private mortgage insurance, or marketing of the GPM?

Dr. KAPLAN. Senator, I am not prepared at this time to give you a specific number as to the likely demand. We have been looking at the data just in the last 2 weeks, and we can provide more detail for the record. What we have been looking at are survey data that have been collected over the last several years on families around the country. The numbers suggest that, in fact, the experience is that incomes do rise across a full spectrum of borrower types, and that large numbers of borrowers could have accommodated GPMs if only they had been available during the last 10 years.

I think that the general availability of these kinds of instruments is going to result in a lot of demand.

As I say, in the next several weeks we hope to refine these numbers so as to give you some better estimates.

Senator BROOKE. Would you submit those for the record?

Dr. KAPLAN. Yes, sir.

Senator BROOKE. You referred to the possibility of a tax credit as an alternative to IHAs. Could you elaborate on the relative advantages of such a credit? Would the advantages of the tax credit outweigh the tax revenue loss to the Federal Government in your opinion?

Dr. KAPLAN. Senator, basically I would have to defer to others as to the technical aspects. This is not an area where we profess any real expertise. Our feeling about the credit as a preferable approach to a deduction is that it would eliminate the regressiveness and

thereby eliminate the significance of the individual's tax bracket as a major factor. And the other factor is that I think it allows one to get a better anticipation of what the tax loss is going to be to the Government.

However, in any event, I do not believe even a tax credit would eliminate the entire problem we have been talking about, but I think it would be an improvement. Whether it would be a more efficient improvement than income limitation, which you have talked about, I am really not in a position to judge.

Senator BROOKE. Can you estimate the tax loss?

Dr. KAPLAN. No, sir.

Senator BROOKE. Dr. Woodworth, what do you feel relative to a tax credit versus my proposal?

Dr. WOODWORTH. I think a tax credit would remove some of the problems with the deduction, but not all of them. There still is the question of those who are in a position to take advantage of it versus those who are not. Obviously a credit or deduction has that problem. But the credit does remove the discrimination in the deduction which tends to benefit those in the higher income brackets. There is another aspect to it, though, and that is the exclusion of the earnings.

I don't see how that could be converted into a credit. As long as you have the exclusion of the earnings, there would always be some tendency to help those in the higher income brackets more.

Senator BROOKE. How about a tax credit and an income limitation?

Dr. WOODWORTH. You mean a limitation on how much of the earnings could be exempt? It might be possible to work something out in that way.

The CHAIRMAN. Would the Senator yield? You are talking about how much earnings could be exempt, or how much the earnings of an eligible buyer would be? Would you limit it to a family making $20,000 or less?

Senator BROOKE. I have already suggested that, yes.

The CHAIRMAN. And in addition you are suggesting this?

Senator BROOKE. Right.

Dr. Shalala, Dr. Rosen who testified yesterday suggested that HUD might expand its graduated payment mortgage to include a 10-year term of graduation, and a 5 to 7½ percent graduation rate. This would, of course, result in even lower monthly payments during the early years of the mortgage, and expand the homeownership market to include more moderate income families.

How would you react to that recommendation?

Dr. BUCKLEY. The 7½ percent graduation wouldn't be allowed under the current limitation on 97 percent maximum loan outstanding.

Senator BROOKE. I was concerned as to whether——

Dr. SHALALA. We would hope to look at that.

Senator BROOKE. You would be concerned about say greater risk of default on those mortgages, particularly since you do not seem to favor the 10-percent downpayment requirement?

Dr. BUCKLEY. The only point I was trying to make is I don't think we can do the second type. The first one we could give you a detailed argument on.

Senator BROOKE. Nothing I have heard has discouraged me. The criticisms which you gave of IHAs, Dr. Woodworth, generally apply to IRA also.

88-114 O - 77 - 20

If I recall correctly, you were instrumental in drafting IRA, as you did many other pieces of tax legislation in your very distinguished career.

The CHAIRMAN. You shouldn't blame Larry for everything when he was told to work on it.

Senator BROOKE. No. He had a distinguished career in the U.S. Senate, and I have the highest admiration and respect for Dr. Woodworth. But I do know that he did draft IRA, among many other bills. Whether he did it at the direction of someone else or not, he always has had a great input into the decisions of the Senate Finance Committee. I think that is a fair statement, Mr. Chairman.

And I know that Treasury has been negative on this proposal. I would hope that you would go back and review the proposed amendments, and contemplated amendments, some of which have been suggested by this very excellent panel today. I hope you would also look at the tax credit Dr. Kaplan has suggested combined with an income limit, and my assurance that this is a first home, and not a rental property which creates some problems for you, as well as other suggestions which have been offered.

I am now receiving about 150 letters a day on this matter. I was happy to hear the chairman's last remarks, and though he has been the Devil's advocate, which is not unusual for him, he has sensitivity to housing in this country, and understands the need for us to do something to stimulate the purchase of a first home for young families. And as he said, we are just looking for some way in which to accomplish this at the least possible cost to the taxpayers, and yet a way that will work.

I don't want to repeat myself, but whether we do it through improved FHA guaranteed loans, tax credit, or IHA's, I think the important thing is that we respond to the problem.

We will be pleased to work with you . . . don't take any pride in authorship . . . and if you can make amendments to the legislation that will improve it, I would be very pleased to have them.

But I assure you that I will not let it rest, because I think that we can perform a great service by passing legislation that will give some relief to first-time home buyers in this country.

I want to thank you for your objective responses to the questions. If I pressed hard at times, it is only because I feel so strongly the need for relief in this particular area.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very, very much. As Senator Brooke has said, you have been a superlative panel, you have been most responsive and given us a fine record. Thank you very much.

Our next witnesses are Mr. David S. Mundel, Deputy Assistant Director, Congressional Budget Office, and Mr. Henry Schechter, director, department of urban affairs, AFL–CIO.

The CHAIRMAN. Mr. Schechter, we are delighted to have you here for a number of reasons. No. 1: You have been a fine expert witness before this committee many many times. You were with the Library of Congress as an expert on housing. Of course now you represent the AFL–CIO. It is good to have the AFL–CIO come before this committee and give us their advice, because they do represent perhaps more working people than any other group or organization, and they represent them very well. And we get very vigorous representa-

tion from the AFL–CIO on matters that affect labor directly, but on something that is indirect like this is we don't get their opinion as often as I think we should. So we welcome your appearance. You have a statement, the hour is late, any way you want to abbreviate it, it will be printed in full in the record.

STATEMENT OF HENRY SCHECHTER, DIRECTOR, DEPARTMENT OF URBAN AFFAIRS, AFL–CIO

Mr. SCHECHTER. I will do some abbreviating. Mr. chairman, Senator Brooke, I appreciate the opportunity to appear before you and present the views of the AFL–CIO on S. 664, the proposed "Young Families Housing Act of 1977," and S. 1078, a bill to amend section 245 of the National Housing Act.

Mr. Chairman, forgive me if I differ slightly with you by saying that we do consider housing of direct interest to our 14½ million members.

The CHAIRMAN. I stand corrected.

Mr. SCHECHTER. Thank you. The AFL–CIO has consistently supported programs for increased housing production to meet the needs of the American people. Housing policy positions adopted by the AFL–CIO have focused particularly on meeting the needs of low- and middle-income families, a group which includes the majority of the 14½ million AFL–CIO members. Those positions reflect a concern for the well-being of such families, which is, no doubt, shared by the sponsors of S. 664 and S. 1078, and members of this committee.

At the same time, the AFL–CIO has opposed and continues to oppose graduated payment mortgages and individual housing accounts because they would increase buyers' costs or cause unnecessary sacrifice of tax revenues. I therefore ask for your careful consideration of our appraisal of the proposed bills.

The percentage of occupied dwelling units that are owner occupied has climbed from 44 percent in 1940 to 63 percent in 1970, and to a current level of 65 percent. Moreover, the 1970 census showed that 39 percent of the one-family homes owned by occupants were free and clear of mortgages. Among homeowners 65 years or older, 85 percent had paid off their mortgages. This tremendous national accomplishment was achieved with fixed-payment, long-term mortgage financing. It is a financing mechanism that has worked well, and untested alternatives should be approached with caution before they are enacted as full-scale programs.

Senator Brooke noted that "There is an increasing proportion of families in the 25- to 34-year-old age group seeking to buy their first homes, and these families are finding that they are unable to buy homes their older brothers and sisters bought just a few years ago."

There is no disagreement with this general assessment, but a significant proportion of young families have been buying homes. Among 30,000 buyers of new homes covered by the homeowners warranty program of the National Association of Home Builders, during 12 months ending June 1976, 56 percent were in the 25 to 34 year age group, and another 6 percent were under 25. The median income of buyers under this program was $21,615.

More directly related to the bills under consideration are data on buyers of new homes with FHA-insured section 203 mortgages. The average age of such buyers during the third quarter of 1976 was about 30½ years and the average income was $19,956. Thus, even among young families, those who have demonstrated upward income mobility have been buying homes. It is those who have lower incomes and have evidenced less upward income mobility who have not been buying homes.

Over the past few years, however, it has become more difficult for families to acquire homes. Prices and costs of homeownership have risen faster than incomes. As noted in a quotation from a Congressional Budget Office study in Senator Brooke's statement of February 10: "The first-time homebuyer is confronted by the full spectrum of cost increases—changes in sales price, interest rate, property tax, hazard insurance, maintenance and repair, and heating and utilities." This is, unfortunately so true, but the graduated payment mortgage would not lower any of these component costs. To the contrary, the graduated payment plan would increase significantly the total cost of attaining free and clear ownership of a home.

When the level of a major component cost, mortgage interest, was lowered for many buyers in 1976, thanks to the Brooke-Cranston Act and market forces, there was a resurgence of effective demand for new homes. More recently, however, interest rates, in general, have begun to move upward and predictions are that mortgage interest rates will also be moving up. Yields have been rising on mortgages which FNMA commits to buy in 4 months. An increase in mortgage interest rates would mean an increase in the margin of extra cost to the homeowner of a graduated payment versus a fixed-payment mortgage.

The extra cost can be seen by examining one of the five graduated payment plans under the HUD section 245 experimental graduated payment mortgage program. It calls for a 3-percent-per-year increase in monthly principal and interest payments for 10 years, with the payment level of the 11th year continuing for the last 20 years of a 30-year, FHA-insured mortgage. The total principal and interest payments on such a graduated payment mortgage at 8 percent interest, plus FHA mortgage insurance premiums, are greater than the comparable total on a fixed payment mortgage by about $5,600 on a $35,000 mortgage and $6,400 on a $40,000 mortgage. This differential would be greater at higher interest rates.

This extra $6,000 paid over the term of the graduated payment mortgage would amount to roughly 1 percent of the lifetime earnings of the average family. Whether or not either of these bills are to be enacted, there should be at least a requirement that the prospective borrower must be advised of the difference between total payments over 30 years required under a section 245 graduated payment mortgage and under a fixed payment mortgage.

Under graduated payment mortgage plans, the outstanding balance of the mortgage loan remains higher than the original loan amount for a number of years. In the plan that I described earlier, the borrower goes deeper into debt for the first 5 years, and the outstanding debt is greater than the original loan for 9 years, by an amount over $1,000 during the fifth and sixth years on a $40,000 mortgage.

Not only is the amount at risk greater than at time of loan origin but the borrower will need to have a rising income to be able to meet increased payments in later years.

While some could exercise the choice of willingly paying $6,000 more in order to acquire a home a few years sooner, others would actually be squeezed out of the market if there is widespread use of the graduated payment mortgage plan. Lenders making graduated payment loans would make them only to borrowers with exceptional potential for upward income mobility. The selectivity would be further reinforced because, pursuant to S. 664, a section 245 mortgage borrower would have to make a greater downpayment than one that is permissible for fixed payment FHA-insured mortgages. Potential buyers who do not have very good prospects for upward mobility or funds for a greater downpayment, but who might be able to meet payments on a fixed payment mortgage, will be less able to compete for available mortgage funds and many will not be able to buy homes.

The requirement for a 10-percent downpayment in S. 664 is designed to avoid a loan amount in excess of the maximum FHA loan-to-value ratio which would be 97 percent in some cases. Under one of the HUD-graduated payment mortgage plans, the outstanding loan amount would actually be more than 3½ percent above the original loan amount in the fourth and fifth mortgage year. Under that plan, where the downpayment at time of purchase was only 3 percent of property value, unless there had been about a 6½ percent appreciation in value in 3 years, the outstanding loan amount would exceed 97 percent of value. If there had been no change in value, the maximum loan-to-value ratio would be exceeded by 6½ percent.

In an apparent attempt to get around this problem, S. 1078 would provide that any outstanding loan amount would be allowable as long as it did not exceed 97 percent of appraised value. As a practical matter, this seems to be a wholly inoperable provision, since HUD cannot appraise values of specific properties several years into the future or conduct annual appraisals. And what happens if the appraised value does not increase and the 97-percent ratio of loan to value is exceeded? Would the loan then be declared in default and the house foreclosed?

There are some statutory barriers to increased cumulative interest charges against mortgage debtors in the laws of 31 States, two territories and the District of Columbia. Interest may not be charged on unpaid interest owed to the lender. Both S. 664 and S. 1078 would provide for Federal preemption of such State laws in order to make interest charges on unpaid graduated payment mortgage interest legal, so that FHA-insured graduated payment mortgages could be made in those States. The State laws were designed to prevent compound interest on delinquent mortgage interest payments. If the State laws are preempted to permit interest charges against uncollected interest on a graduated payment mortgage, will it not establish a precedent that would make it logically indefensible to prohibit a lender from charging interest on uncollected interest on a fixed payment mortgage?

In the case of the fixed payment mortgage, a charge on delinquent interest is prohibited, and yet in the case of the graduated payment mortgage, the charges could be levied against interest which is not

delinquent. So it would be hard to see how one could be opposed to the former if the latter is permitted.

The enactment of such a preemptive provision would be a significant step toward eradication of borrower protection in the majority of the States.

In addition to all the other potential problems inherent in graduated payment mortgages, a conjunction of required increased payments with rising unemployment could produce an unusually high default rate.

Dr. Kaplan has cautioned that the graduated payment mortgages would be only for those with prospects for rising income, not for those whose income had no prospect of rising. I don't see how he could then conclude that increased cyclical unemployment, which results in lower incomes, would not have an adverse effect, would not result in an adverse experience for lenders and borrowers with the graduated payment mortgages.

I believe the experimental program should be carried at least through one complete business cycle. The original concept of an experimental program enacted by the Congress should be retained. Such an experiment can very well be carried on in 19 States where a preemption of State laws is not needed. In some of these States there is also a good deal of conventional graduated payment mortgage lending, which can supplement the section 245 experience with FHA-insured loans. The section 245 program should not be made permanent, as both bills provide, nor should it be made unrestricted in volume, as an amendment in S. 1078 would do.

The second major proposal of S. 664 would amend the Internal Revenue Code to permit deductions from taxable income of amounts deposited in individual housing accounts and interest thereon, patterned after individual retirement accounts.

I think previous witnesses have pointed out many of the questions with regard to the IHA. I would emphasize one objection, and that is the inequity, the fact that the benefits would go primarily to those of higher income. And in addition, many of those with higher income would not be in need of the tax benefit which they would obtain anyway. It would be an unnecessary use of the funds, an unnecessary loss of tax revenue.

Therefore, as Senator Brooke indicated, it might be a tax loophole. We consider it a tax loophole, not only if it is legal, but if it is a legal deduction that would benefit somebody who might otherwise not use savings for home purchase, who would take advantage of it.

Now the AFL-CIO is in accord with the idea of providing assistance for those who need it to acquire homes because they have limited incomes. For that reason, we have supported homeownership programs, such as the HUD section 235 and the Farmers Home Administration section 502 programs, and the tandem plan below-market interest rate financing. These programs should be continued, with appropriate modification of the tandem plan to prohibit its benefits going to buyers with adequate income to pay the full market costs of homeownership. Under such programs, unlike the IHA proposal, the subsidies are confined to people who would not be able to buy a home without the benefits of the program.

[The complete statement of Mr. Schechter follows:]

Statement of Henry B. Schechter, Director
AFL-CIO Department of Urban Affairs
Before the Senate Committee on Banking, Housing and Urban Affairs
on
S. 664 "Young Families' Housing Act of 1974"
and
S. 1078, a bill to amend Section 245 of the National Housing Act

April 1, 1977

I appreciate the opportunity to appear before you and present the views of the AFL-CIO on S. 664, the proposed "Young Families' Housing Act of 1977" and S. 1078, a bill to amend Section 245 of the National Housing Act.

In convention resolutions, in Executive Council policy statements, and in testimony before Congressional committees, the AFL-CIO has consistently supported programs for increased housing production to meet the needs of the American people. Housing policy positions adopted by the AFL-CIO have focused particularly on meeting the needs of low- and middle-income families, a group which includes the majority of the 14½ million AFL-CIO members. Those positions reflect a concern for the well-being of such families, which is, no doubt, shared by the sponsors of S. 664 and S. 1078 and members of this committee. At the same time, the AFL-CIO has opposed and continues to oppose graduated payment mortgages and Individual Housing Accounts because they would increase buyers costs or cause unnecessary sacrifice of tax revenues. I, therefore, ask for your careful consideration of our appraisal of the proposed bills.

Graduated Payment Mortgage Insurance Act

In his statement accompanying the introduction of S. 664, in the Congressional Record of February 10, 1977, Senator Brooke made several significant observations. He said, "Homeownership has been the principal way in which American families acquired equity and a stake in our society." Indeed, it has been, and the percentage of occupied dwelling units that are owner-occupied has climbed from 44 percent in 1940 to 63 percent in 1970 and to a current level of 65 percent. Moreover, the 1970 Census showed that 39 percent of the 1-family homes owned by occupants were free and clear of mortgages. Among homeowners 65 years or older, 85 percent had paid off their mortgages. This tremendous national accomplishment was achieved with fixed payment, long term mortgage financing. It is a financing mechanism that has worked well, and untested alternatives should be approached with caution before they are enacted as full scale programs.

Senator Brooke also noted in his statement, accompanying the introduction of S. 664, that "There is an increasing proportion of families in the 25- to 34-year old age group seeking to buy their first homes, and these families are finding that they are unable to buy homes their older brothers and sisters bought just a few years ago." There is no disagreement with this general assessment, but a significant proportion of young families have been buying homes. Among 30,000 buyers of new homes covered by the Home Owners Warranty Program of the National Association of Homebuilders, during 12 months ending June 1976, 56 percent were in the 25- to 34-year age bracket and another 6 percent were under 25. The median income of buyers under this program was $21,615. More directly related to the bills under consideration are data on buyers of new homes with FHA-insured Section 203 mortgages. The average age of such buyers during the third quarter of 1976 was about 30½ years and the average income was $19,956. Thus, even among young families, those who have demonstrated upward income mobility have been buying homes. It is those who have lower incomes and have evidenced less upward income mobility who have not been buying homes.

Over the past few years, however, it has become more difficult for families to acquire homes. Prices and costs of homeownership have risen faster than incomes. As noted in a quotation from a Congressional Budget Office study in Senator Brooke's statement of February 10: "The first time homebuyer is confronted by the full spectrum of cost increases -- changes in sales price, interest rate, property tax, hazard insurance, maintenance and repair and heating and utilities." This is, unfortunately, so true, but the Graduated Payment Mortgage would not lower any of these component costs. To the contrary, the Graduated Payment plan would increase significantly the total cost of attaining free and clear ownership of a home.

When the level of a major component cost, mortgage interest, was lowered for many buyers in 1976, thanks to the Brooke-Cranston Act and market forces, there was a resurgence of effective demand for new homes. More recently, however, interest rates, in general, have begun to move upward and predictions are that mortgage interest rates will also be moving up. Yields have been rising on mortgages which FNMA commits to buy in four months. An increase in mortgage interest rates would mean an increase in the margin of extra cost to the homeowner of a graduated payment versus a fixed payment mortgage.

The extra cost can be seen by examining one of the five graduated payment plans under the HUD Section 245 experimental graduated payment mortgage program. It calls for a 3 percent per year increase in monthly principal and interest payments for 10 years, with the payment level of the eleventh year continuing for the last 20 years of a 30-year FHA-insured mortgage. The total principal and payments on such a graduated payment mortgage at 8 percent interest, plus FHA mortgage insurance premiums, are greater than the comparable total on a fixed payment mortgage by about $5,600 on a $35,000 mortgage and $6,400 on a $40,000 mortgage. This differential would be greater at higher interest rates.

This extra $6,000 paid over the term of the graduated payment mortgage would amount to roughly 1 percent of the lifetime earnings of the average family. Whether or not either of these bills are to be enacted, there should be at least a requirement that the prospective borrower must be advised of the difference between total payments over 30 years required under a Section 245 graduated payment mortgage and under a fixed payment mortgage.

Under graduated payment mortgage plans, the outstanding balance of the mortgage loan remains higher than the original loan amount for a number of years. In the plan that I described earlier, the borrower goes deeper into debt for the first five years, and the outstanding debt is greater than the original loan for nine years, by an amount over $1,000 during the fifth and sixth years on a $40,000 mortgage. Not only is the amount at risk greater than at time of loan origin, but the borrower will need to have a rising income to be able to meet increased payments in later years.

While some could exercise the choice of willingly paying $6,000 more in order to acquire a home a few years sooner, others would actually be squeezed out of the market if there is widespread use of the graduated payment mortgage plan. Lenders making graduated payment loans would make them only to borrowers with exceptional potential for upward income mobility. The selectivity would be further reinforced because, pursuant to S. 664, a Section 245 mortgage borrower would have to make a greater down payment than one that is permissible for fixed payment FHA-insured mortgages. Potential buyers who do not have very good prospects for upward mobility or funds for a greater down payment, but who might be able to meet payments on a fixed payment mortgage, will be less able to compete for available mortgage funds and many will not be able to buy homes.

The requirement for a 10 percent down payment in S. 664 is designed to avoid a loan amount in excess of the maximum FHA loan-to-value ratio, which would be 97 percent in some cases. Under one of the HUD graduated payment mortgage plans, the outstanding loan amount would actually be more than 3½ percent above the original loan amount in the fourth and fifth mortgage year. Under that plan, where the down payment at time of purchase was only 3 percent of property value, unless there had been about a 6½ percent appreciation in value in three years, the outstanding loan amount would exceed 97 percent of value. If there had been no change in value, the maximum loan-to-value ratio would be exceeded by 6½ percent.

In an apparent attempt to get around this problem, S. 1078 would provide that any outstanding loan amount would be allowable, as long as it did not exceed 97 percent of appraised value. As a practical matter, this seems to be a wholly inoperable provision, since HUD cannot appraise values of specific properties several years into the future or conduct annual appraisals. And what happens if the appraised value does not increase and the 97 percent ratio of loan-to-value is exceeded? Would the loan then be declared in default and the house foreclosed?

There are some statutory barriers to increased cumulative interest charges against mortgage debtors in the laws of 31 states, two territories and the District of Columbia. Interest may not be charged on unpaid interest owed to the lender. Both S. 664 and S. 1078 would provide for Federal preemption of such state laws in order to make interest charges on unpaid graduated payment mortgage interest legal, so that FHA-insured graduated payment mortgages could be made in those states. The state laws were designed to prevent compound interest on delinquent mortgage interest payments. If the state laws are preempted to permit interest charges against uncollected interest on a graduated payment mortgage, will it not establish a precedent that would make it logically indefensible to prohibit a lender from charging interest on uncollected interest on a fixed payment mortgage? Enactment of such a preemptive provision would be a significant step toward eradication of borrower protection in the majority of the states.

In addition to all the other potential problems inherent in graduated payment mortgages, a conjunction of required increased payments with rising unemployment could produce an unusually high default rate. The experimental program should be carried at least through one complete business cycle. The original concept of an experimental program enacted by the Congress should be retained. Such an experiment can very well be carried on in 19 states where a preemption of state laws is not needed. In some of these states, there is also a good deal of conventional graduated payment mortgage lending, which can supplement the Section 245 experience with FHA-insured loans. The Section 245 program should not be made permanent, as both bills provide, nor should it be made unrestricted in volume, as an amendment in S. 1078 would do.

The program has barely begun. Only a handful of loans have been made, all in the last few months. It should not be turned into a permanent, unrestricted program until the program has been tested for potential problems.

Individual Housing Account Act

The second major proposal of S. 664 would amend the internal revenue code to permit deductions from taxable income of amounts deposited in Individual Housing Accounts and interest thereon, patterned after Individual Retirement Accounts. Up to $2,500 per year, and a total of up to $10,000 could be deposited in an Individual Housing Account (IHA). All the funds in the IHA trust account could be used only for purchase of a principal residence within 10 years of the initial deposit. Any violation of this rule would cause all of the funds in the account to become taxable, and a 10 percent penalty to be levied on the amount used for non-housing purposes.

That is, essentially the Individual Housing Account plan, as it was proposed in 1976 in S. 3692. A HUD representative in testifying on that proposal, said:

"If enacted, the program would be potentially very costly to the Treasury, since it subsidizes the savings of many who would have bought homes anyway. As an example, we have used data from the Annual Housing Survey to estimate the cost of Individual Homeowners Account. In both 1973 and 1974, 2.5 million renter households purchased their first home. If we apply the average down payment, this represents a total of $25 billion in savings. At the median income tax rate of 25 percent, there is a tax loss of $6.25 billion. This tax loss serves no purpose; it goes to people who already are planning to buy homes. In order to encourage new buyers, the tax loss must be greater."

This year in S. 664, there is a provision designed to recapture part of the tax loss resulting from IHA accounts when the house is sold. For purposes of future capital gains tax calculations, the adjusted basis of a home purchased with proceeds from an Individual Housing Account would be reduced by the amount of such proceeds. Income that had been exempt from taxation under the IHA plan prior to purchase of the house would become subject to capital gains taxation if and when the house is sold at a higher price. However, since only one-half of such capital gains are considered taxable income, the unpaid taxes on one-half of the IHA funds used for home purchase would not be paid in any case.

Moreover, where the seller of a house realizes a capital gain, but buys a higher priced house within 18 months, the tax payment can be deferred, and the basis of the new house is adjusted downward by the amount of the capital gain. This procedure can be repeated until the owner is 65 or older. At that time, a gain on a house sold for $35,000 or less is exempt from taxation; the capital gain on a house sold for more is reduced by the percentage ratio of $35,000 to the sales price. Non-elderly owners selling homes generally buy another one and defer payment. Thus, if a person over 65 sells a home with an adjusted (value) basis of $60,000 for $70,000, the capital gain of $10,000 is reduced to $5,000 by the application of the ratio of $35,000 to $70,000, or 50 percent. In addition, since only one-half of such capital gains are considered taxable income, perhaps one-fourth of the income tax not paid on IHA funds used in the house purchase would be recaptured. In most cases, the proportion of lost tax revenue captured would be even less, since the income and the income tax rate at age 65 or older is likely to be less than at the time of the initial house purchase.

In addition, the government loses the interest on deferred taxes during the years of deferment. If the deferral period is between 10 and 20 years, the interest cost would eat up 50 to 100 percent of the capital gains tax that would eventually be paid. The net result would be that only a minor part of the cost of the IHA income taxes lost, perhaps 10 percent, would ever be regained. Even if only a fraction of the maximum potential of $6½ billion annual tax loss estimated by HUD in 1976 should come to pass, the enactment of the IHA proposal would entail billions of dollars of tax revenue losses.

The greatest benefits of the IHA plan would accrue to those who need it least, those with substantial incomes. Individuals earning substantial salaries, who would normally place $2,500 or more a year in savings, and who would normally buy a house in the course of the next 10 years, would certainly take advantage of the IHA plan. Those who cannot put away $10,000 in savings prior to purchasing a home could not take full advantage of the proposal, and those who cannot take advantage of the IHA plan at all would gain nothing. The AFL-CIO opposes the creation of another very costly tax loophole to benefit primarily the well-to-do for which the rest of the taxpayers will pay.

The AFL-CIO is in accord with the idea of providing assistance for those who need it to acquire homes because they have limited incomes. For that reason, we have supported home ownership programs, such as the HUD Section 235 and the Farmers Home Administration Section 502 programs, and the tandem plan below-market interest rate financing. These programs should be continued, with appropriate modification of the tandem plan to prohibit its benefits going to buyers with adequate income to pay the full market costs of homeownership. Under such programs, unlike the IHA proposal, the subsidies are confined to people who would not be able to buy a home without the benefits of the program.

The CHAIRMAN. Thank you very much, Mr. Schechter.

Our final witness is Dr. David S. Mundel, deputy assistant director, Congressional Budget Office.

STATEMENT OF DAVID S. MUNDEL, DEPUTY ASSISTANT DIRECTOR, CONGRESSIONAL BUDGET OFFICE

The CHAIRMAN. Before you go ahead, let me say how good it is to have the Congressional Budget Office testify. It is one of those rare occasions, it may be a first, but it is most reassuring and helpful to have our own Congressional Budget Office come up and give us their opinion on the effect that this legislation will have on the budget and on our fiscal policy.

Mr. MUNDEL. Thank you very much. Mr. Chairman, I appreciate the opportunity to come before you today and talk about the problem of homeownership affordability and the two bills under discussion.

I would like to insert in the record my testimony and a copy of a recent study that the Congressional Budget Office did on homeownership affordability.

The CHAIRMAN. Without objection, that will be done.

Mr. MUNDEL. In order to save time, let me paraphrase my testimony briefly.

The testimony focuses on four areas. First: The budget tradeoffs involved in providing additional homeownership assistance within the Federal budget.

Second: Some recent changes in homeownership affordability that we examined in the budget issue paper.

Third: The potential impact of the two pieces of legislation under consideration today on these changes in homeownership affordability.

And, fourth: A brief description of some alternative mechanisms that the committee may want to consider in alleviating this problem.

First: With regard to the budget tradeoffs, homeownership affordability is only one of several problems toward which Federal housing assistance can be directed. As I note on table 1 in the testimony, homeownership assistance currently receives substantial emphasis within Federal housing activity. The fiscal year 1977 housing budget, implied by the Third Concurrent Resolution, includes about $1.4 billion in outlays on budget, another $3.7 billion in outlays off budget, and approximately $12.2 billion in foregone tax revenues.

Of this $17.3 billion total, approximately $11 billion provides assistance directly to homeowners through tax expenditures. Additional support to homeowners is provided through the section 235 moderate income housing assistance program and also through the Farmers Home Administration programs that Mr. Schechter mentioned earlier.

With regard to the second aspect, homeownership affordability problems, I think it is important to recognize two points.

One: These problems confront different households quite differently. And second: In spite of the decline in affordability that we have experienced over the last few years, families have increasingly become homeowners.

As we note in table 2 of the testimony, first-time buyers of homes on average suffered substantial declines in affordability between 1970 and 1975. The annual housing costs for first-time buyers of median-priced new homes rose almost twice as fast as did their incomes and if they bought median-priced existing homes, the cost rose about one and a half times as fast as did their incomes over this time period.

Downpayments also rose faster than family income for first-time buyers, although the problem of declining affordability is more a problem of monthly carrying costs than a problem of downpayments. Downpayments grew more slowly in comparison with family income than did monthly carrying costs.

Other people who were already homeowners, on average had incomes rising faster than did their cost of housing during the same period. This holds true both for people who own a home and do not move, and for people who own a home and move and purchase a home of essentially similar quality.

The changes in affordability have been essentially constant across the income spectrum. Family incomes at the bottom part of the income distribution have grown at about the same rate as family incomes in the median part of the income distribution and at the top.

For lower income families, the real problem is not so much a change in affordability, but the fact that they could not generally afford homeownership in 1970, and the capacity to afford homeownership for these families declined between 1970 and 1975. Because low-income families were disproportionately renters at the beginning of the period, they would also disproportionately be first-time buyers and, therefore, the people who are hurt the hardest by the purchase of a house.

First-time buyers numbered about 2 million households in 1974. Some of these were new households, others of these were people who had been renter households. These households had family heads who were, on average, less than 35 years of age, and the median income of the first-time buyers was about $14,000, slightly higher than the median income for all families.

With regard to the pattern of homeownership, first-time buyers experienced substantial declines in homeownership affordability between 1970 and 1975, but the proportion of all households owning homes went up. For all households, the proportion of homeowners went from 63 percent in 1970 to about 65 percent in 1974. For younger households, those with family heads in the 25 to 34 year age bracket, the percentage of homeowners was about 57 percent in 1970, and by 1974 this percentage had grown to about 64 percent. We do not have data on the patterns of homeownership by age or for families as a whole into 1975. The data from the 1975 housing survey is not yet available.

The potential impact of the legislation under consideration today on these problems of homeownership affordability is the third area of my remarks. The affordability decline has been experienced both with regard to monthly housing costs and to downpayments.

Graduated payment mortgages—(GPM's)—can improve affordability by reducing the monthly mortgage payments in the early years

below the payments required under a level-payment mortgage. We have done a few calculations, shown in table 4 in the testimony, which portray the kind of change in monthly housing costs that would occur under the GPM provisions which HUD would allow under the proposed law.

A household buying a medium priced new home in 1975, assuming a 25 percent down payment and a 30-year mortgage with an 8½ percent interest rate, would pay under a normal FHA insured loan approximately $240 in monthly mortgage payments. If we wanted to maintain that family at the level of affordability that it would have experienced in 1970, we would have to reduce the monthly costs to the neighborhood of $145. These are the monthly costs during the first year of the mortgage and do not include the costs for taxes and other upkeep.

The graduated payment mortgage provisions would move the family closer to the affordability conditions which it experienced in 1970, but would not, even under the most substantial graduated payment program current planned (with a 7½ percent annual payment increase), move it all of the way toward the 1970 level of affordability.

We have also done some calculations with regard to a family buying a median priced existing home. Existing house costs went up considerably less rapidly than did new house costs during the 1970–75 period. A family buying a median priced existing house in 1975 would pay approximately $215 in monthly mortgage payments during the first year of an FHA-insured loan. If we wanted to maintain this family at the 1970 level of affordability, we would have to reduce the monthly mortgage costs to $165. Both the 5 percent annual increase graduated payment mortgage and the 7½ percent annual increase graduated payment mortgage would move purchasers of medium priced existing houses into the neighborhood of $165 per month mortgage cost.

The second aspect of the legislation relates to the tax-free individual housing account. And as our testimony shows, we have done some analysis of this, but we have not done a projection of the total budget cost.

What we find, as shown in table 5 of the testimony, is that the tax savings resulting from the tax free nature of the contributions to the individual housing account would be larger for higher income families. For example, if a family with $9,000 adjusted gross income contributed $1,000 to such an account, it would save about $165 in taxes, whereas a family with an adjusted gross income of $27,500 would save about $320.

The pattern of tax savings across family income groups is perhaps understated by a horizontal line in table 5. I think it is very likely that higher income families will be able to save more and therefore their tax savings would be on average more than twice the tax savings of lower income families.

This, of course, assumes the legislation as currently written. The assistance for downpayments provided by the individual housing accounts is targeted for first-time homebuyers, who as a group suffered substantial declines in homeownership affordability during the last 5 years.

However, those with the most severe problems of affordability are lower income first-time buyers, and also lower income people who are renting. With substantially larger benefits of the currently proposed housing accounts being provided to higher income levels, it appears that the tax-free accounts would largely have the impact of letting higher income renters accumulate a down payment faster than they would otherwise, or at substantially less cost. This proposal may not provide much improvement in the affordability of down payments for low- and moderate-income renter households.

As to some possible alternatives, I think that the committee may want to consider whether to expand the section 235 program, which reduces annual mortgage costs through annual subsidies for interest reduction.

There are also proposals to reduce interest rates through one-time lump sum subsidies, such as those provided by the GNMA tandem plan.

Other types of alternative mortgage instruments, such as deferred payment mortgages, could also be used for lowering monthly carrying costs.

With regard to reducing the costs of down payments, tax credits, as opposed to deductions, are one alternative for improving the targetting of the tax benefits. The discussion this morning about perhaps including income eligibility limits for Individual Housing Accounts would also improve the targetting of the benefits resulting from these accounts.

The committee may also want to consider reductions in FHA down payment requirements. But reducing the down payment, also will increase the monthly costs, unless there is a subsidy mechanism included.

That covers the major points in my testimony, and I would be happy to discuss with you today, and discuss with you and your staff later, possible improvements to the legislation.

[The complete statement of Mr. Mundel and the Congressional Budget Office report follow:]

88-114 O - 77 - 21

STATEMENT OF DAVID S. MUNDEL

DEPUTY ASSISTANT DIRECTOR FOR EDUCATION, EMPLOYMENT,
HOUSING AND COMMUNITY DEVELOPMENT

HUMAN RESOURCES AND COMMUNITY DEVELOPMENT DIVISION

CONGRESSIONAL BUDGET OFFICE

Mr. Chairman and Members or the Committee:

I am pleased to be here to discuss with you the problem of homeownership affordability and two bills (S. 664 and S. 1078) that are directed at this problem. As you are aware, homeownership costs have risen rapidly in recent years. Concern over the decreasing ability of many families to afford homeownership is reflected in many recent proposals.

My remarks today will focus on four areas:

1. The budget trade-offs involved in directing more assistance toward homeowners and the current emphasis on homeownership assistance in federal spending on housing;

2. The recent changes in homeownership affordability for particular categories of homeowners. This subject is discussed in a recent Congressional Budget Office report: Homeownership: The Changing Relationship of Costs and Incomes, and Possible Federal Roles; 1/

3. The potential impact on homeownership affordability problems of the proposal included in both bills to expand Federal Housing Administration insurance of graduated payment mortgages and of the proposal included in S. 664 for tax-free individual housing accounts; and

4. A brief description of some alternative mechanisms to address homeownership affordability problems.

1/ Other papers prepared by the CBO that focus on federal housing policies include: The Section 8 Housing Programs: Budget Issues, July 1976; Housing Finance: Federal Programs and Issues, September 1976; A Budgetary Framework for Federal Housing and Related Community Development Policy, February 1977, and Housing Assistance for Low- and Moderate-Income Families, February 1977.

BUDGET TRADE-OFFS

Homeownership affordability is only one of the problems toward which federal housing assistance can be directed. Within a limited budget, funds spent on programs assisting homeowners compete with funds spent on programs which address other housing problems, such as the excessive housing costs and low housing quality of many low- and moderate-income households who are predominantly renters. Decisions to implement homeownership assistance programs that require subsidies necessarily involve either larger federal deficits or budget trade-offs with programs that address other national problems and needs.

Homeowner assistance currently receives substantial emphasis in federal housing activity. The fiscal year 1977 housing budget includes \$1.4 billion outlays in the unified budget, \$3.7 billion outlays for off-budget entities, and \$12.2 billion foregone revenues through housing-related tax expenditures (see Table 1). Of this total net support of \$17.3 billion, at least \$11 billion directly assists homeowners through tax expenditures. Much of the on- and off-budget outlays also assist homeowners through mortgage credit programs but the amount of direct benefits to homeowners from these activities cannot be readily identified. Moderate-income homeowners are also assisted by the Section 235 interest subsidies included in the housing assistance component of the housing budget.

TABLE 1. THE HOUSING BUDGET, FISCAL YEAR 1977 a/, IN MILLIONS OF DOLLARS

	Budget Authority	Outlays
ON-BUDGET		
Mortgage Credit & Thrift Insurance (401)	$3,189	$-2,205
Community Development-Housing Related (part of 451)	700	523
Housing Assistance (part of 604)	28,110	3,089
Totals: On-Budget	$31,999	$1,407
OFF-BUDGET ENTITIES-HOUSING RELATED	$8,107	$3,700
TAX EXPENDITURES-HOUSING RELATED		
Homeowner Benefits		$10,965 b/
Other		1,200 b/
Total Foregone Revenues		$12,165 b/

a/ On-budget estimates from third concurent resolution, off-budget and tax expenditure estimates from the President's fiscal year 1978 budget.

b/ Foregone revenues.

HOMEOWNERSHIP AFFORDABILITY PROBLEMS

The bills under discussion today propose additional homeownership assistance in order to ease the affordability problems resulting from increases in house prices and operating costs. To assess the impact of these increases on homeownership affordability, it is important to note that these increases would affect different groups of homeowners differently and that the incomes of homeowners are also rising.

The recent Congressional Budget Office study of this issue examined changes in homeonership affordability over the 1970 to 1975 period and found that the situation facing different groups of current or potential homeowners differed significantly. Mr. Chairman, with your permission I would like to insert this report in the record. In summary the findings are shown in Table 2 and indicate that:

- First-time buyers of homes on average suffered substantial declines in affordability between 1970 and 1975. Annual carrying costs for first-time buyers of median new homes rose almost twice as fast as their incomes, and their costs for median existing homes rose one-and one-half times as fast as income. Downpayments rising faster than incomes also contributed to the problem of declining affordability for first-time buyers.

- Other homeowners on average had incomes rising faster than their housing costs for the same period. Typical families already owning a home who moved to another during the period benefited from increased value in the homes they sold. These repurchasers could apply that increased value against the increased price of the houses they purchased. Homeowners who didn't move faced only increases in operating costs. The incomes of these nonmovers increased about twice as fast as their housing costs.

TABLE 2: PERCENT CHANGES IN HOUSING COSTS, INCOME, AND GENERAL CONSUMER PRICES, 1970-1975

	Percent Change
Monthly Housing Costs For:	
First-Time Buyer of Existing Housing	63.0%
First-Time Buyer of New House:	
Median-priced (not controlled for quality)	82.4
Controlled for quality	59.8
Rebuyers (assuming buying similar house)	27.3
Nonmovers	22.8
Downpayment Costs for First-Time Buyer of:	
Existing housing	53.6
Median-priced new house	67.9
New house controlled for quality	48.4
Median Family Income	39.0
Consumer Price Index	38.6

These changes in affordability were essentially the same for all income groups, because families at all income levels experienced approximately the same rate of income growth between 1970 and 1975. For lower-income families the real problem is not changes in affordability but the fact that they could not generally afford homeownership even in 1970. Because these families were disproportionately renters in 1970, they would in general have been first-time buyers if they became owners between 1970 and 1975. Homeownership affordability became even

more limited for lower-income renters between 1970-1975. Thus, changes in homeownership affordability affected first-time homebuyers most severely. The continuing problem is most severe for lower-income families.

First-time homebuyers numbered about two million households in 1974 constituting roughly one-half of all homebuyers. They were predominantly younger families headed by persons less than 35 years old and with median income of about $14,000, or somewhat higher than the $12,900 median income of all families (see Table 3).

TABLE 3: CHARACTERISTICS OF FIRST-TIME HOMEBUYERS, 1974 a/
(Percentage Distribution of 1.91 Million Households)

Age of Head of Household		18-24	25-34	35-44	45-64	65+
		15.3%	47.1%	19.3%	15.5%	2.9%

Family Income (median income = $13,998)	Less than $5,000	$5,000-$9,999	$10,000-$14,999	$15,000-$19,999	$20,000-$24,999	$25,000 and over
	6.2%	20.7%	29.1%	21.1%	11.7%	11.3%

a/ First-time buyers characteristics are dervied from the data in the 1974 Annual Housing Survey about recent movers who were renters before and homeowners after moving. Two qualifications to this data are: (1) it includes an unknown number of households who owned homes in the past, became renters and then homeowners again, and thus aren't really first-time buyers; and (2) it excludes 630,000 homebuyers who had a different household head before moving, therefore missing such groups as newly married couples buying homes after living singly with their parents.

POTENTIAL IMPACT OF S. 664 AND S. 1078 ON AFFORDABILITY PROBLEMS

The bills under consideration today propose programs that could assist homebuyers with affordability problems due to both carrying costs and downpayment costs. Initial annual carrying costs would be reduced by the graduated payment mortgages insured by the Federal Housing Administration (FHA). Funds for down payments would be easier to accumulate with the tax-free individual housing accounts proposed in S. 664. I would like to discuss each of these proposals in terms of their federal costs, who they would benefit, and by how much.

Insurance of Graduated Payment Mortgages

Graduated payment mortgages can improve affordability by reducing monthly mortgage payments in early years below the payments required by the level payment mortgage now generally used. Higher payments are required in later years. These increases in payments are expected to be paralleled by increases in the homeowner's income. Both S. 664 and S. 1078 would expand authority for FHA insurance of these mortgages. This could increase homeownership affordability with no direct federal costs if lenders will make graduated payment mortgages and if insurance premiums cover the actual losses on defaulted mortgages. 2/

2/ There is uncertainty about potential losses from insurance of these loans both from the risk of default if a particular homeowner's income doesn't increase as expected and from the limited degree of risk sharing possible with only a small number of insured loans.

The federal cost of insuring graduated payment mortgages and whether borrowers would actually benefit depend in part on whether incomes do increase as fast as the mortgage payments. Under both of these bills, FHA plans to insure five different types of graduated payment mortgages with payments increasing at rates up to 7 1/2 percent per year. Median-family incomes have increased at rates of about 7 percent per year over the 1965-1975 decade, and at 6.8 percent per year from 1970 to 1975. For younger families (who are the major group of first-time homebuyers), income may be expected to grow faster than the average as they reach ages of peak earning power. This was the case between 1965 and 1975 when the median income of households with heads aged 25-34 in 1965 grew by 8.5 percent per year. Thus the proposed rates of increase in mortgage payments don't seem unreasonably high compared to past income growth. The rate of income growth in the future is, of course, uncertain and primarily a function of the growth in the economy as a whole.

The amount of benefit derived from reducing early year homeownership costs would be significant under the five types of mortgages to be insured by FHA. A first-time buyer of a median priced new house in 1975 would have had monthly mortgage payments of $239 with a level payment FHA insured loan at 8 1/2 percent (see Table 4). The five graduated payment mortgage plans would have reduced those payments by anywhere from $21 to $56 per month (under the plan that has payments increasing by 7 1/2 percent per year). However, these reductions would not have been

sufficient to fully offset declines in affordability since 1970 for first-time buyers of new homes. For total carrying costs to be the same proportion of median income in 1975 as they were in 1970, mortgage payments for the first-time buyer of the median priced new house would have to be reduced by $95, to $144 per month. The effect of the graduated payment mortgage alternatives on restoring the affordability conditions of first-time buyers of existing housing would also be substantial.

TABLE 4: COMPARISON OF MONTHLY MORTGAGE COSTS FOR 1975 MEDIAN PRICED NEW HOUSE (25 percent downpayment, 8.5 percent interest rate, 30-year term)

Type of Loan	Monthly Mortgage Payment in First Year
Normal FHA-Insured Loan	$239
Graduated Payment Loan	
2% annual increase for 10 years	212
3% annual increase for 10 years	200
2 1/2% annual increase for 5 years	218
5% annual increase for 5 years	200
7 1/2% annual increase for 5 years	183
To Maintain 1970 Level of Affordability	144

Tax Free Individual Housing Accounts

Section 3 of S. 664 proposes that up to $2,500 per year deposited in special savings accounts--called Individual Housing Accounts--could be deducted from gross income for federal tax purposes.3/ The resulting reduction in income taxes would make it easier to save toward purchase of a house and hence improve the affordability of downpayments. Unlike insurance of graduated payment mortgages, this proposal would involve federal costs through tax expenditures or foregone revenues. I believe the Treasury Department is estimating the magnitude of these potential tax expenditures and their results will be important for considering the budget tradeoffs.

I would like to focus on who will benefit from these tax provisions, how much benefit they will receive, and the targeting of those benefits toward people with the severe homeownership affordability problems. Like all tax deductions this proposal will be of more benefit to higher income tax payers. For each dollar deposited they save more in taxes than lower income taxpayers who have lower tax rates. Higher income people are also likely to be financially able to make larger deposits into individual housing accounts.

3/ We have been advised that the present bill inadvertently omits a restriction against present homeowners using Individual Housing Accounts and assume that appropriate amendment would be made.

Table 5 shows the impact of the proposed individual housing accounts for a married couple with one child at different income levels. By depositing $1,000, a couple with $9,000 income 4/ would save $165; a couple with $14,000 income, or about middle income, would save $212; and a couple with $27,500 income would save $320. By depositing $2,500 the tax savings are increased at each income level but are still about twice as large at the $27,500 income level as compared to $9,000 income. Because higher income people are more likely to make larger Individual Housing Account deposits than lower income people, actual tax savings are likely to be more than twice as large for families at the higher income level.

TABLE 5. IMPACT OF INDIVIDUAL HOUSING ACCOUNT AT DIFFERENT INCOME LEVELS a/

	Adjusted Gross Income Before Deduction of Individual Housing Account Deposit					
	$9,000	$11,000	$14,000	$17,500	$22,500	$27,500
Tax Savings from $1,000 Deposit	$165	$190	$212	$226	$280	$320
Tax Saving from $2,500 Deposit	$397	$460	$497	$556	$662	$773

a/ Assumes married couple filing jointly with one dependent, having the average amount of nonhomeowner itemized deductions of all taxpayers at their income level, and standard deduction of $3,000 as proposed by the President.

4/ This and following references to income refer to adjusted gross income before deducting the Individual Housing Account deposit.

The assistance for downpayments provided by individual housing accounts is targeted for first-time homebuyers, who as a group recently suffered declines in homeownership affordability. However, those with the most severe problem are lower income first-time buyers. With the substantially larger benefits at higher income levels, it appears that tax-free individual housing accounts would largely have the impact of letting higher income renters accumulate a downpayment faster than they would otherwise. This proposal may not provide much improvement in the affordability of downpayments for low- and moderate-income renters.

ALTERNATIVE MECHANISMS TO ADDRESS THE HOMEOWNERSHIP AFFORDABILITY PROBLEM

Other possible options to reduce mortgage payment and operating costs include:

1. Reduce interest rates with annual subsidies as in the Section 235 program;
2. Reduce interest rates with one lump sum subsidy as in the GNMA Tandem program in which the federal government buys below market interest rate mortgages and then resells them at a loss; and
3. Other types of alternative mortgage instruments such as deferred payment mortgages that involve partial payment of of mortgage costs by the federal government in early years with later repayment with interest.

Other options to reduce downpayment costs include:

1. Tax credits, as opposed to deductions, for renters' saving toward downpayments which could improve the targetting of tax benefits toward lower income families; and

2. Reductions in FHA downpayment requirements which would make downpayments more affordable but have the major problem that potential homebuyers with relatively low income would be hard pressed to meet the enlarged monthly payments that smaller downpayments necessarily produce.

3. Insurance of second mortgages that are paid back only in later years of the main mortgage loan. Such insurance could involve little federal cost if premiums covered the cost of defaults.

SUMMARY

To reduce the requirement for additional budget resources, new programs to improve homeownership affordability could be designed that involve little or no budget cost. One such approach is insurance of graduated payment mortgages that reduce carrying costs in early years of homeownership. The cost reductions under graduated payment mortgages are not large enough though to return first time buyers to 1970 level of affordability or to make homeownership affordable to lower income people.

Another way to reduce the federal cost of homeownership assistance programs is to target assistance toward those most in need or to target assistance toward lower cost housing. First-time homebuyers and low- and moderate-income households have the greatest homeownership affordability problem. The proposed tax-free individual housing accounts

target assistance toward first-time buyers, but in a way that will most likely be used by higher income renters. Restricting assistance to buyers of existing, as opposed to new, homes would reduce federal costs because the prices are generally lower and are rising more slowly.

That concludes my prepared testimony, Mr. Chairman. I will be happy to answer any questions you and other committee members may have.

BUDGET
ISSUE PAPER

Homeownership: The Changing Relationship of Costs and Incomes, and Possible Federal Roles

January
1977

Congressional Budget Office
Congress of the United States
Washington, D.C.

PREFACE

The 95th Congress will be considering legislation to continue or revise programs to assist homeowners. How difficult the problems of buying and maintaining a home have become and for whom these problems are most severe are among the questions that are bound to influence the Congress' deliberations about the extent and type of federal assistance to make available. This Budget Issue Paper examines the changes that have occurred between 1970 and 1975 in households' ability to afford their own homes. In addition, the report discusses some proposals to make homeownership easier.

The paper was prepared by Neil S. Mayer of the Human Resources Division of the Congressional Budget Office, under the supervision of David S. Mundel and C. William Fischer. Jill Bury typed the several drafts. The manuscript was edited and prepared for publication under the supervision of Johanna Zacharias.

Alice M. Rivlin
Director

January 1977

88-114 O - 77 - 22

TABLE OF CONTENTS

LIST OF TABLES

SUMMARY

Is it becoming more difficult for an American family to buy and maintain its own home? This is the question known as "homeownership affordability." This paper examines changes in homeownership affordability over a five-year period, 1970-1975, then discusses several proposals that would affect affordability in the future.

Budget impacts of proposed measures could vary widely. Proposals directed toward macroeconomic conditions--increasing income growth and slowing the general rise in all prices, including housing--take many forms at various costs. For home-purchase subsidy programs, costs per family differ substantially with who is served and how. Numbers of eligible and likely participants also differ from program to program. Furthermore, many of the proposals are not entitlement programs--not all eligible people are guaranteed program benefits. In such cases, the Congress can directly choose maximum budget levels and thereby determine the number of families assisted.

To make choices about the level and type of support for homeownership, the Congress might want to consider

- o The extent of the affordability problem and who suffers it, and
- o The likely effectiveness of and distribution of benefits under proposed solutions.

One reasonable measure of changes in homeownership affordability is the change in the relation between income levels and costs of homeownership. But there is no satisfactory measure of changes in homeownership costs for all homeowners as a single group. The patterns of housing costs for various categories of homeowners are very different.

Categories of Homeowners

Cost changes from 1970 to 1975 had quite different effects on three distinct categories of homeowners:

- Families buying a home (new or existing) for the first time during the period--first-time buyers.
- Families already owning a home who move to another during the period--repurchasers.
- Families already owning a home who remain in place during the period--non-movers.

The first-time homebuyer is confronted by the full spectrum of cost increases--changes in sales price, interest rate, property tax, hazard insurance, maintenance and repairs, and heating and utilities. But the family which already owns a house, the repurchaser, may well have any increase in house sales prices reflected in both the price at which it can sell its present house and the price of the house to be purchased. The sales proceeds can obviously be applied to the purchase price. To the extent of this offset, the family confronts increases only in the cost components other than purchase price (but including interest rate changes). The family staying in its present house, the non-mover, faces no change in purchase price and interest rate (and thus no change in mortgage payment) and is confronted only by increases in "operating" expenses (property taxes, hazard insurance, maintenance and repairs, and heating and utilities).

Who Has The Affordability Problem?

First-time purchasers of homes (about half of all homebuyers in a given year) on average suffered substantial declines in affordability between 1970 and 1975, with their costs for median new homes rising almost twice as fast as their income, and their costs for existing homes rising one-and-one-half times as fast as

income. 1/ This was true for young families, who make up the bulk of first-time buyers, as well as for families as a whole. Still, the proportion of young families and all families owning their own homes did continue to grow through 1974 (latest data available, which miss the effects of high unemployment and inflation in 1975).

Typical repurchasers benefited from increased value in the homes they sold--value that could be applied against the increased price of the houses they purchased. As a result, these repurchasers generally had incomes rising faster than their housing costs for the same five-year period--about one-and-one-half times as fast for families buying a home of the same value as their present one and whose original home rose in value at the same rate as median house prices. Homeowners wishing to buy more expensive homes than their present ones necessarily faced greater cost increases, but nonetheless they could buy somewhat more valuable houses without facing faster rises in housing costs than in incomes.

Homeowners who did not move during the period (over half of all homeowners), and thus faced increases only in housing operating costs, had incomes rising even faster relative to costs. These non-movers not only did not become "housepoor" over the period, but on average increased their incomes about twice as fast as their housing costs. Typical elderly non-movers, the focus of some particular concern, fared even better than the average.

Changes in homeownership costs, incomes, and general prices are summarized in the following table.

1/ The median new home appears to have increased modestly in quality over the 1970-1975 period. The cost of a new house of fixed quality increased about 1 3/4 times as fast as income.

PERCENT CHANGES IN HOUSING COSTS, INCOME, AND GENERAL CONSUMER PRICES, 1970-1975

Housing Costs For:	
First-time buyer of existing housing	63.0
First-time buyer of new housing	
Median-price (not controlled for quality)	82.4
Controlled for quality	59.8
Rebuyers (assuming buying similar house)	27.3
Non-movers	22.8
Median Family Income	39.0
Consumer Price Index	38.6

Changes in affordability (income to housing cost ratios) do not differ significantly between income groups, because families in various parts of the income spectrum experienced approximately the same rate of income growth during the 1970-1975 period. However, the real difficulty for low income families is quite different. They were not generally able to afford homeownership even at the beginning of the period. The five-year cost increases did outstrip their income increases (for people not presently owning houses, which is more common for lower-income households), but their affordability problem was already acute before that.

In interpreting all these results, it is important to note that the experiences of other groups--subdivided by such characteristics as geography, race, or sex of household head--were not separately examined. The geographical problem is particularly difficult. Because of the extremely local nature of housing markets, we do not know to what extent lower money incomes predominate in areas where housing costs are also systematically lower. It is also important to remember that the results represent averages, and that even within the categories examined there will in fact be substantial variation in income and housing cost increases.

Have Downpayments Become More Burdensome?

Potential homebuyers must not only have incomes adequate to meet monthly payments; they must also be able to meet downpayment requirements. Downpayments for conventionally-financed home purchases also generally became more burdensome for first-time homebuyers during the period. Sales prices of both existing and new houses rose faster than median incomes, while the typical down-payment remained fairly even as a percentage of sales prices (about 25 percent). As a result, downpayments on median existing houses rose more than one-and-one-quarter times as fast as annual incomes, and on median new houses almost one-and-two-thirds times as fast. Repurchasers, on the other hand, had no difficulty meeting the downpayment for a different home, if their original house had shared in even a small part of the general increase in sales prices.

Which Homeownership Costs Have Increased Most?

Breaking down the sources of increase in total homeownership costs for a first-time buyer, sales price increases played the largest role. While operating expenses (insurance, property taxes, maintenance and repairs, and heating and utilities) increased at faster rates than sales prices, sales price dominated because of its large proportion in total costs. Interest rates had less impact because they increased relatively slowly. No single subcomponent of sales price accounted for a very substantial share of the total homeownership cost increase.

Important Policy Criteria

In order to judge the usefulness of policy alternatives in dealing with housing affordability problems, the following criteria can be used:

- What types of homeowners/homebuyers are assisted (first-time purchasers, repurchasers, non-movers)?
- Does the alternative have substantial impact on housing costs?

- o Is the impact sustainable?
- o What is the income distribution of the people helped by the program?
- o What are the budget impacts for the federal government?
- o How is housing construction activity affected by the alternative?

These criteria are used to frame the analyses of program/budget alternatives and their general effects.

Program/Budget Alternatives and Their General Effects

Federal policy to deal with homeownership affordability can be broken into four major types of action:

- o Changes in macro-economic policy
- o Actions to limit increases in specific components of housing costs
- o Homeownership subsidies
- o Development of alternative mortgage instruments.

Obviously, macroeconomic policies that improved the rate of growth of incomes relative to the general price level would benefit all homebuyers.

To focus on limiting cost inflation of particular subcomponents of house purchase prices is less promising, both because no individual element has a high weight in total cost and because the federal government probably has only limited ability to control many of the costs. Some actions might be taken to help limit subcomponent cost increases to general inflation rates.

The federal government has more impact on mortgage interest rates. These offer a helpful but limited lever, since interest rates are not as greatly above historical levels as are other costs, and they cannot be continually moved lower if inflation continues to outstrip income growth.

Subsidizing homepurchasing is generally expensive, even just to return middle-income potential purchasers to 1970 levels of affordability. Two changes in subsidy programs might reduce subsidy cost. First, the eligible group might be narrowed to first-time homebuyers, since they in general are the group which has suffered most from decreases in affordability in recent years. Second, aid might be switched to buyers of existing housing (in contrast to present Section 235 and GNMA Tandem programs limited to new housing), which is in general cheaper than new housing. Of course, this latter approach does not meet other economic stimulus objectives.

It is important to realize that the relatively modest subsidies contained in major current homeownership assistance programs limit their use essentially to people of middle income and above. While providing deep subsidies to low- and moderate-income people may or may not be a federal objective, it should be noted that the shallow homeownership subsidies provided in current subsidy programs essentially trade off, in a constrained federal housing budget, against housing assistance (rental or homeownership) to those groups.

A potentially useful alternative approach for middle-income first-time homebuyers is to encourage the use of mortgages that begin with lower early payments that rise over time. This approach allows the buyer to take advantage of future growth in income (from inflation and possibly from improved earning power) while limiting federal government expenditures.

The following table summarizes the impacts of major policy types according to the suggested criteria. These impacts are explained in more detail in Chapter V.

[illegible]

[illegible]	[illegible]	Impact on housing costs	Sustainability of impact
[illegible]	[illegible]	Potentially substantial	High
[illegible]	[illegible]	Potentially substantial	Difficult to sustain particularly if trying to offset continuing rise in costs relative to income
[illegible]	All, depending on which submarkets	Very limited for any given submarket alone	Limited
[illegible] Section 235 [illegible]	Purchasers of new homes, first-time or repurchasers	Modest because subsidies not too deep	Limited in face of continuing price rise relative to income
[illegible]	Potentially limited to first-time purchasers and/or existing housing	Depends on subsidy level	Limited in face of continuing price rise relative to income
Graduated and deferred payment mortgages	All, but should be limited to first-time buyers and/or existing homes	Moderate, because substantially lowered initial payments require rapid increase	Limited in face of continuing price rise relative to income

a/ Annual annual per unit cost for units reserved in 1976.

b/ Actual one time cost per unit in 1976

c/ Estimated first-year cost for program to return median income first-time purchaser of existing housing to 1970 affordability position as of 1976

SUMMARY OF POLICY IMPACTS (continued)

Income Distribution of People Assisted	Effect on Housing Construction	Budget Impacts
All income groups, and perhaps particularly lower-income people	Significantly favorable	Depends on mechanisms used
Mainly middle- and upper-, since lower-income people cannot afford to become homeowners without deeper assistance	Significantly favorable	Depends on mechanisms used
All, depending on subcomponent	Limited because of limited cost impact	Depends on mechanisms used
Limited largely to middle- and upper-income	Favorable, but often substitutes for activity which would occur anyway	$ 850 a/ $1,819 b/
Potentially including lower- and moderate-income if deeper subsidies	Limited, if directed away from new construction	$ 635 c/ or $1,235 d/
Middle- and upper-income, and upwardly mobile moderate-income	Depends on targeting toward or away from new home purchasing	Deferred $635 e/ Graduated: some tax expenditures and insurance costs

d/ Estimated first-year cost for program to move first-time purchaser at 40th percentile of income distribution to 1970 affordability for median income buyer, as of 1975.

e/ As in footnote c/, but note that in later years subsidies would be repaid

CHAPTER I INTRODUCTION

In recent years substantial concern has arisen about the decreasing ability of families in the United States to afford their own homes. Several current federal programs have been designed at least in part to assist the households in buying homes. But concern that it is becoming more difficult to afford a home has led to a number of proposals to ease home purchase, either directly or indirectly.

The budget impacts of these proposed measures could vary widely. Proposals directed toward macroeconomic conditions--increasing income growth and slowing the general rise in all prices, including housing prices--take many forms at various costs. For housing subsidy programs, costs per family differ substantially with who is served and how. It is difficult to estimate the numbers of eligible and likely participants under any given program, but such estimates are crucial in determining expected costs and desirable funding levels.

Furthermore, many of the programs generally envisioned are not entitlement programs. That is, not all eligible people are guaranteed program benefits, as they are under programs like the food stamp program. Therefore the Congress can directly control the programs' maximum budget levels, thereby choosing the number of families to assist.

To aid Congressional decisions about the level and type of support for homeownership, this paper:

- Examines the affordability problem to see to what extent it exists and for whom, and

- Evaluates several types of proposed solutions according to a number of criteria.

Whether assisting homeownership is an appropriate federal function at all is, of course, a critical policy question. Current policies do provide major encouragement to homeownership, presumably on grounds that homeownership furthers such values as family and neighborhood stability

and participation in a private-ownership economy. But homeownership is a form of private investment and consumption that policy-makers might not wish to encourage over other forms. This paper does not address the broader policy question of whether the federal government should play any role, since that is clearly a judgmental question largely not subject to analysis.

CHAPTER II CATEGORIES OF HOMEOWNERS

The changes in homeownership affordability from 1970 to 1975 are the subject of this analysis. Changes in affordability turn on changes in the relation between incomes and housing costs for the period under study.

There is no reasonably satisfactory measure of changes in homeownership costs for all homeowners as a single group. The patterns of housing costs for distinct categories of homeowners are quite different. The three key categories studied in this paper are:

- Families buying a home (new or existing) for the first time during the period (first-time buyers).
- Families already owning a home who move to another during the period (repurchasers).
- Families already owning a home who remain in place during the period (non-movers).

The first-time buyer is confronted by the full spectrum of cost increases--changes in sales price, interest rate, property tax, hazard insurance, maintenance and repairs, and heating and utilities. The repurchaser, however, may well find any increase in house sales prices reflected in both the sales price of the present house and the price of the house to be purchased. The sales proceeds can obviously be applied to the purchase price. To the extent of the offset, the repurchasing family confronts increases only in the cost components other than purchase price (but including interest rate changes). The non-mover (i.e., the family staying in its present house) faces no change in purchase price and interest rate (and thus no change in mortgage payment) and is confronted only by increases in "operating" expenses (property taxes, hazard insurance, maintenance and repairs, and heating and utilities).

Any measure of the experience of all homeowners together would involve essentially a weighted average of the very different experience of homeowners in these

categories. 1/ No available data provide such a weighted average. 2/ Furthermore, from the standpoint of public

---

1/ The situation is even more complicated than suggested in the preceding paragraph. For people who are already homeowners (repurchasers and non-movers), the rate of overall housing cost increase depends on when and at what price and interest rate they originally bought their house. For repurchasers, the change in value of their original house is an important cost change determinant.

2/ The homeownership component of the Consumer Price Index (CPI) does not provide such a weighted average. It is fairly close to the cost changes for first-time buyers purchasing and operating a mixture of new and and existing homes. But it is not really satisfactory for measuring that mixed category either (which would be better analyzed separately for new and existing housing), because: (1) the initial weights established for different subcomponents are based in part on the experience of repurchasers; (2) heating and utilities are not included in the homeownership component, and the separate utilities series is for renters and homeowners combined; (3) measurements of property tax changes are based on a fixed set of houses with no adjustments for new construction; and (4) maintenance and repair costs are obtained from the costs for a very small set of particular goods and services and entered with weights established more than 10 years ago (as are all the subcomponents). Moreover, the lack of public reporting of several of the subcomponent series minimizes its usefulness for the analysis contained in this paper. Therefore, the CPI homeownership component is not used in this paper. Other data sources are used to trace cost changes for definable categories of homeowners, but no measure of cost changes for all homeowners together is available. The basic data used are: National Association of Realtors Existing Home Sales Series and Commerce Department Prices of New One-Family Houses Sold, for home purchase prices; Federal Home Loan Bank Board conventional mortgage rate series, for mortgage interest rates; and FHA characteristics for Section 203 homes, for operating expenses (property taxes, hazard insurance, maintenance and repairs, heating and utilities).

88-114 O - 77 - 23

policy toward homeownership affordability, it is not very useful to measure the experience of all homeowners taken together when the experiences of distinct categories are known to be very different.

Chapter III of this paper therefore compares the separate cost experiences of the three key categories of homeowners with changes in incomes. Incomes used are those of the population at large or its age and income subgroups, rather than of particular homeowner categories, because our interest is in the general ability of families to enter and stay in the various categories rather than in the incomes of those who do.

Housing cost subcomponents (purchase price, interest rate, etc.) are also measured for the total set of houses in each case, rather than the set of houses actually being purchased or lived in by the particular homeowner categories, since the total set provides a more reliable measure of the actual changes that confront homeowners (and influences their housing choices and therefore the category in which they in fact end up).

Affordability change differences for the various homeowner categories arise not from differences in the basic data employed, but from differences in the set of housing cost subcomponents applicable to each group: changes in all costs for first-time buyers, in all costs but purchase price (in full or in part) for repurchasers, and in operating expenses only for non-movers.

Details of methodology are provided in the Appendix.

CHAPTER III CHANGES IN HOMEOWNERSHIP AFFORDABILITY FOR CATEGORIES OF HOMEOWNERS

As stated above, each of three categories of homeowners--first-time buyers, repurchasers, and non-movers--faces a different set of cost increases, resulting in very different rates of change of overall costs. The experience of each of these groups is analyzed separately below. In each case, the focus is change in affordability between 1970 and 1975, as measured by the change in income compared to change in housing costs. The results are summarized in Table 9 at the end of this chapter.

It is important to note at the outset that the results are essentially averages. But we know that different categories of households--classified by such characteristics as geography, race, and sex of head of household--may have faced significantly different experiences. The geographical problem is particularly difficult. Because of the extremely local nature of housing markets, we do not know to what extent lower incomes predominate in areas where housing costs are also systematically lower. An effort is made to look at affordability for people with incomes lower than the median, but it is necessarily hampered by lack of knowledge about how available cheaper houses are in the areas where low-income people live. Also, even within the type-of-homebuyer categories examined here (first-time buyer, repurchaser, non-mover), there undoubtedly are wide variations in experience. Some effort is made to indicate within what bounds the stated average results will apply.

FIRST-TIME HOMEBUYERS

Approximately 50 percent of homebuyers in recent years are purchasing homes for the first time (about 2

million first-time buyers in 1974). 1/ As of 1974, nearly two-thirds (about 46 million) of U.S. households were homeowners already. This proportion has been steadily rising for 30 years. The first-time homebuyers come from the remaining one-third of existing households and from newly formed households. First-time purchasing is particularily common among the growing set of households in the 25-34 year age classification, comprising nearly half of first-time buyers (see Table 1).

TABLE 1. FIRST-TIME HOMEPURCHASERS BY AGE OF HOUSEHOLD HEAD, 1974

Age	18-24	25-34	35-44	45-64	65+
	15.3%	47.1%	19.3%	15.5%	2.9%

SOURCE: 1974 Annual Housing Survey, Part D, U.S. Bureau of the Census.

NOTE: Age figures for first-time purchaser household heads are available only for households with the same head before and after moving. Thus new households buying houses immediately after formation are not represented in this table. Such households comprise about one-fourth of total first-time buyers.

1/ Based on numbers of renters and new households becoming homeowners, as estimated in the Annual Housing Survey. The estimate overstates first-time buyers to the extent that some renters becoming homeowners in a given year will have been homeowners at some earlier time.

Low-income households are much more likely not to be present homeowners (see Table 2), but their low incomes also make them less likely to be purchasers in a given year.

TABLE 2. HOMEOWNERSHIP BY INCOME OF HOUSEHOLDS, 1974

Income Group	Total Households (in 1,000s)	Percent Owners	Percent Renters
$ 0- 4,999	15,653	48%	52%
5,000- 9,999	16,875	55	45
10,000-14,999	15,878	68	32
15,000-24,999	15,519	79	21
25,000 or more	6,907	87	13
TOTAL	70,832	65%	35%
Median income	$10,831	$12,800	$7,700

SOURCE: Annual Housing Survey, 1974.

Actual and potential first-time buyer families have experienced fairly substantial decreases in their ability to afford homes, as measured by the relationship of changes in annual housing costs to changes in incomes. 2/ Consider first the first-time buyer of an existing home. Assume the buyer family considers purchasing the median-priced existing home in each of the years 1970 to 1975,

2/ Incomes of families, rather than of all households (including those made up of single or unrelated individuals), are the focus here because families are the likely homebuying group.

and that its income follows the growth path of national median family income. The annual housing cost of supporting that home (mortgage payment and operating expenses including utilities) increased from about $2,650 in 1970 to about $4,320 in 1975. That amounted to a 63.0 percent increase for the whole period, for an annual rate of 10.3 percent (see Table 3). 3/ This was substantially faster than the increase in median income over the same period, 39.0 percent or a 6.8 percent annual rate. And the substantially faster rise of cost than incomes occurred in each of the last four years.

TABLE 3. HOUSING COSTS AND COST CHANGES FOR A FIRST-TIME HOMEBUYER OF AN EXISTING HOME IN EACH YEAR 1970-1975

	Annual Housing Cost	Monthly Housing Cost	Percent Change	
1970	$2,648	$221	70-71	5.9%
1971	2,810	234	71-72	9.4
1972	3,071	256	72-73	11.7
1973	3,432	286	73-74	14.3
1974	3,918	327	74-75	10.2
1975	4,317	360	70-75	63.0%

SOURCES: Purchase price. National Association of Realtors Existing Home Sales Series.

Mortgage interest rate. Federal Home Loan Bank Board effective interest rate on conventional loans series in FHLBB Journal.

Operating expenses. From characteristics of FHA Section 203 home sales in HUD Statistical Yearbook.

3/ The annual rates are compound rates of growth, so that the 5-year rates will not be simple multiples of annual rates.

Great attention has traditionally been focused on the ability of families, including first-time buyers, to purchase new homes. This ability is important in terms of construction industry activity, its contribution to macroeconomic conditions, and its contribution to increasing and improving the housing stock. It is far less clear that the government should be concerned whether first-time homebuyers can afford to purchase new houses in particular. The data for changes in their affordability are nonetheless provided here for comparison. Construction costs of new houses (though not necessarily the total of all cost components) are probably most important to first-time buyer affordability in terms of their impact on purchase prices for existing housing. New house prices help to set a limit on prices of existing houses, though exact relationships between the prices are difficult to establish.

New-house total costs to first-time buyers have risen substantially faster than costs of existing housing, and about twice as fast as median incomes in the past five years. Annual costs rose from about $2,600 in 1970 to about $4,750 in 1975, an increase of 82.4 percent for an annual rate of 12.8 percent (see Table 4). The ability of first-time buyers to afford median new housing thus declined very substantially in the period. Note further that the annual cost for median new housing is $435 greater than for median existing housing. This will also have a substantial impact on how affordable the housing is to people of various incomes.

TABLE 4. HOUSING COSTS AND COST CHANGES FOR A FIRST-TIME HOMEBUYER OF A MEDIAN PRICE NEW HOME

	Annual Housing Cost	Monthly Housing Cost	Percent Change	
1970	$2,604	$217	70-71	6.0%
1971	2,761	230	71-72	11.3
1972	3,072	256	72-73	19.2
1973	3,662	305	73-74	21.2
1974	4,437	370	74-75	7.1
1975	4,751	396	70-75	82.4%

SOURCE: Purchase price, in Characteristics of New One-Family Homes Sold, Construction Report C-25, Department of Commerce. Other costs, see Table 3.

The median-priced new house seems to have increased in quality over the five-year period, since its sales price increased somewhat more rapidly than that of the Commerce Department's fixed-quality house 4/ (67.9 percent versus 48 percent). The changes in all housing costs for first-time buyers of the fixed-quality new house 5/

4/ Fixed at the average quality of houses built in 1967.

5/ The median price existing house should not have changed too much in quality over the five-year period, since new construction, demolition, repair, and deterioration would not have great impact on the quality of the housing stock as a whole in such a relatively short period. Of course, there may be some additional change in observed sales price because of some change in the set of houses being sold for whatever reason. But no data are available to represent prices of existing housing that is unchanged in quality, so that no separate consideration of this possible complication was possible.

are presented in Table 5a. The rate of cost increase is somewhat slower than for the median new house (59.8 percent versus 82.4 percent). But that rate of increase is still very substantially greater than the growth of median incomes in the same period, so that first-time buyers of new houses again are in a worse "affordability" position in 1975 than in 1970. Also, the price of this fixed-quality new house is even higher than that of the median new house (see Table 5b). As a result, purchasing this new house in 1975 costs over $800 more per year than purchasing the median price existing house in the same year ($5,135 vs. $4,317).

TABLE 5a. COST CHANGES FOR A FIRST-TIME HOMEBUYER OF A FIXED-QUALITY NEW HOME

	Annual Housing Cost	Monthly Housing Cost	Percent Change	
1970	$3,213	$268	70-71	5.1%
1971	3,378	282	71-72	6.2
1972	3,589	299	72-73	11.9
1973	4,016	335	73-74	16.0
1974	4,659	388	74-75	10.2
1975	5,135	428	70-75	59.8%

TABLE 5b. CHANGES IN SALES PRICES OF NEW HOMES

	Median-Price New House	Fixed-Quality New House
1970	$23,400	$28,900
1975	39,300	42,900
Percent Change	67.9%	48.4%

SOURCE: Purchase price, Construction Report C-27, Department of Commerce. Other costs, see Table 3.

Focusing on income of age groups concentrated in the first-time buyer class, we find the same pattern of decline in affordability of existing and new houses for first-time buyers. Median incomes of families with 25-34 year old heads of household rose at almost precisely the same rate as overall family median income. Incomes for this age group rose from $9,853 to $13,659, a 38.6 percent increase, matching overall median income both in level and rate of change to a remarkably high degree. Thus first-time buyers in general and in this particular age concentration both lost ground in their ability to become homeowners.

Nor is the pattern of affordability for first-time buyers substantially changed when families in various income categories are examined separately. Consider the top level of income for each quintile of families (i.e., the income below which 20 percent, 40 percent, 60 percent, and 80 percent of U.S. families' earnings lie). Each of the quintile income cut-offs rose at very nearly the same rate as the median income (see Table 6), which was the basis for the comparisons above. Thus first-time purchasers in all income groups suffered similar declines in homeownership affordability. 6/

6/ This conclusion assumes that the rate of increase in costs of first-time homeownership is the same for houses of different qualities (and locations) which people of different incomes tend to buy. Good evidence is not readily available on this assumption. But the large difference between income increases and median cost increases suggests that the decline in affordability would be observed even if fairly significant differences existed in rates of cost increase.

TABLE 6. CHANGES IN FAMILY INCOME QUINTILES, 1970-1975

	1st Quintile	2nd Quintile	3rd Quintile	4th Quintile	Median
1970	$5,100	$8,320	$11,299	$15,531	$9,867
1975	6,914	11,465	16,000	22,037	13,719
Percent Change	35.6%	37.8%	41.0%	41.9%	39.0%

SOURCE: Incomes of Families and Persons in the United States, Department of Commerce.

NOTE: For use in other calculations, median family incomes were $10,285 in 1971, $11,116 in 1972, and $12,051 in 1973.

Furthermore, the affordability decline is not significantly affected by considering incomes net of income taxes. It has been suggested that increased value of deductions allowed homeowners for mortgage interest and property taxes might moderate increases in housing costs relative to incomes. Deduction values for buyers of median houses have risen from 1970 to 1975, because the amount of interest and property taxes rose, and because higher marginal tax rates on increased incomes meant greater tax savings per dollar of deduction. The relevant measure of affordability, however, is change in net of tax income relative to change in housing costs. The same increase in tax rates that raised the value of deductions also works generally to raise taxes and lower net incomes. The result is that for a median-income family of four that bought a median-priced existing house, net of tax income (given the more valuable deductions) rose at very nearly the same rate as gross income. Thus, for the first-time buyers, net incomes also rose substantially less quickly than housing costs.

It is well worth noting, however, that at least through 1974 (the latest available data), the proportion of all households (of two or more persons) owning their own homes continued to rise (from 67 percent in 1970 to 70 percent in 1974), as did the homeowner proportion of households with 25-34 year old heads (from 56 9 percent in 1970 to 63.7 percent 7/ in 1974). Apparently the affordability problem for the first-time purchaser was not so great by 1974 to disturb this long-term trend. But the situation could worsen with continued cost increases.

BUYERS OF HOMES WHO ARE ALREADY HOMEOWNERS

Many purchasers of homes are already homeowners (about 50 percent in 1973 and 1974). This is not surprising, since nearly two-thirds of current households were homeowners in 1974, and about 2.9 million homeowner households moved (to another house or a rental unit) in the year 1973-1974.

Changes in housing costs for families already owning homes should be thought of as including increases in all cost components including purchase price but netting out year-to-year increases in the price they can obtain for their present house. That increase, after all, presumably results from the same forces which increase the price of the next house, 8/ is obtainable on sale, and could be (though it may not necessarily be) applied against the purchase price of their next house if desired.

7/ Age-disaggregated data in the Annual Housing Survey are available only for households with two or more persons and both parents present, so that these data are limited to that category of households.

8/ The windfall nature of this increase, comparable to the windfall nature of price increase of the next house, argues for the simple offset without including an opportunity cost of the additional equity.

Consider this example. Assume that a homeowning family owns a median-priced existing house in 1970. The house increases in price at the same pace as the general median-priced house over the period 1970-1975. The household considers purchasing another median-priced existing house each year. The increase in equity (value of home above outstanding mortgage amount) is just enough to offset increased purchase prices (neglecting transaction costs and leaving mortgage amount fixed), so that cost increases between possible years of purchase derive only from changes in interest rates and from operating expenses. 9/ The resulting rate of change in total costs for the repurchaser is much slower than for first-time buyers.

If the repurchasing family above buys in 1975, it faces only a total 27.3 percent increase in homeownership cost above 1970 costs. Annual costs increase from about \$2,650 to about \$3,370, an annual rate of increase of about 4.9 percent (see Table 7). This increase is significantly slower than the rate of growth of median income--39.0 percent for the period, 6.8 percent annually.

Interest rates in 1970 were at a cyclical peak and are therefore more crucial here because changes in purchase price net out. Therefore, it is worth looking at the potential repurchaser's experience from 1971 to 1975 only. In that period, costs increased more slowly than median incomes--24.9 percent compared to 33.4 percent. Even for the high-inflation, low-real-growth period of 1973-1975, increases in costs for the repurchaser were outstripped by increases in median incomes.

9/ If the family wishes to buy a more expensive house than its present one, and that house is increasing in cost at the same rate, then some cost increase will result from net purchase price growth. The same is true for a family wishing to buy a new house whose price is increasing at a faster rate than that of its existing house.

TABLE 7. HOUSING COSTS AND COST CHANGES FOR A SECOND-TIME HOMEBUYER OF AN EXISTING HOME IN EACH YEAR 1970-1975

	Annual Housing Cost	Monthly Housing Cost	Percent Change	
1970	$2,648	$221	70-71	1.6%
1971	2,691	225	71-72	5.0
1972	2,826	236	72-73	6.8
1973	3,019	252	73-74	7.2
1974	3,240	270	74-75	4.1
1975	3,371	281	70-75	27.3%

SOURCE: CBO calculations based on assumptions specified in text and data as in Table 3. See Appendix for further detail on methodology.

The repurchaser's present house may rise in value less rapidly than the intended next house, even if it begins at the same value. But the margin of income growth is large enough that the present house need increase in value only about 75 percent as fast as the next house in order for incomes to rise as fast as housing costs. Even families wanting to move from a median existing house to a median new house face only a moderately higher increase in cost than in income (50 percent versus 39 percent).

Can repurchasers move to better homes? It is clear from the above paragraph that some improvement in house quality is possible. To consider the question more directly, consider the following example. Suppose again that the household in 1970 owns a median-price existing house, that it rises in value to 1975 at the same rate as the general existing median house, and that the repurchaser applies the equity increase to its next house purchase. Suppose also that the family's income

increases at the same rate as the median income (though it need not in fact have the median level income).

That family could, with the same share of its income applied to housing in 1975 as in 1970, afford to buy a house greater in value than the median by 7 percent (about $2,300)--an annual rate of growth of about 1.25 percent in the relation of quality of the affordable second house to the original home. And this upward step would be available to homeowners no more upwardly mobile in income than the general population (traditionally, movement to better homes has been associated with a family's improved position in the income spectrum), even though real incomes in terms of all prices (housing and non-housing) remained generally constant. However, the rate of improvement in housing quality affordable was slower for 1970-1975 than for 1966-1970. The rise in median income would have allowed a 1966 purchaser of the median house to buy a house about 16 percent more valuable than the median four years later, an annual rate of about 3.7 percent.

These results do not change for different income categories. As indicated above, incomes of various income groups rose at essentially the same rate during the period in question, so that the relation of changes in incomes to changes in homeownership costs is the same across incomes. 10/

Thus for the typical household already owning a home, the last five years have not been harmful in terms of affording a house comparable to their present one. People may, of course, have been disappointed about their limited ability to "move up" to a better home compared to their past experience. But they fared better in terms of homeownership than for all goods and services in general, since median real income remained constant over the five year period.

10/ Given again the assumption that the costs associated with different qualities of houses did not vary appreciably, with again a substantial margin for error.

HOMEOWNERS WHO DO NOT MOVE DURING THE PERIOD

Families that already owned homes at the start of the 1970-1975 period and did not move faced no increase in mortgage payments (due to changes in either principal or interest). Cost increases confronting non-movers arose only from increased operating costs (insurance, property taxes, maintenance and repairs, and heating and utilities). As a result, the rate of increase in their overall housing cost was lower than for movers.

In particular, homeownership costs for non-movers who bought median-priced houses in 1970 increased only 22.6 percent over the next five years, for an annual rate of 4.2 percent (see Table 8). This was well below increases in median income.

TABLE 8. HOUSING COSTS AND COST INCREASES FOR NON-MOVER HOMEOWNERS, 1970-1975

	Annual Housing Cost	Monthly Housing Cost	Percent Change	
1970	$2,652	$221	70-71	5.0%
1971	2,784	232	71-72	5.6
1972	2,940	245	72-73	4.7
1973	3,072	256	73-74	2.6
1974	3,144	262	74-75	3.4
1975	3,252	271	70-75	22.6%

SOURCE: See Table 3. Because of imperfections in the FHA operating cost data used, another estimate was made for comparison using the 1970 FHA figures as a base and CPI component inflators. The result was still slower increases in housing costs, 15.6 percent for the five-year period.

Of course, homeowners may have purchased their homes well before 1970, so that their mortgage payments are lower than those used in Table 8 and increases in operating costs thus have more impact on total housing costs. However, a non-mover making payments on a mortgage initially as small as $7 800 at only 5 percent interest will still have had housing costs rising no faster than income in the past five years, provided again that the family's income rose as fast as median income. This typical non-mover is not decreasing and is probably increasing in ability to afford the actual costs of its current home.

Once again, non-movers in various income categories generally gained ground in affordability in about the same fashion as people following the path of median income, since income increased at similar rates for all categories.

Particular concern has often been expressed that elderly homeowners may have been forced out of their homes by rising costs. This does not seem to be the prevailing pattern for 1970-1975. Income of families with heads over 65 rose 59.4 percent from 1970 to 1975, an annual rate of 9.8 percent. Income of unrelated individuals over 65 did equally well. Thus income increases for the elderly far outstripped non-mover homeownership cost increases for recent buyers. Indeed, rates of income increase for the elderly kept even with non-mover homeownership cost increases even in cases where no mortgage payments were being made at all. 11/

11/ It is perhaps the case that the income increase for people already elderly in 1970 is overstated by the 1975 figures since the latter figures reflect past higher incomes of people becoming elderly during the five-year period. Truly satisfactory data to test this possibility are not available. Rough-cut efforts suggest this is not a substantial effect--particularly not large enough to reverse the direction of affordability change reported above, because of the wide margin between income growth and homeownership cost growth for elderly non-movers. The direction might be reversed for elderly people with little or no mortgage payment whose incomes rise significantly less rapidly than those of the elderly population in general.

88-114 O - 77 - 24

Thus non-movers overall and in particular groups generally gained ground in homeownership affordability as measured by growth in income versus growth in cost. No doubt some owners grew more "housepoor" over time, but that was certainly not the general pattern.

Table 9 summarizes the results for rates of homeownership cost increase for different categories of homeowners in relation to increases in median income and general price levels.

TABLE 9. PERCENT CHANGES IN HOUSING COSTS, INCOMES, AND GENERAL CONSUMER PRICES, 1970-1975

	Increases in Housing Costs						
	First-Time Buyers						
	Of Existing Housing	Of New Housing (not controlled for quality)	Of New Housing (controlled for quality)	Repurchasers (assuming buying similar house)	Non-movers	Median Family Income	CPI
1970-1971	5.9	6.0	5.1	1.6	5.0	4.2	4.3
1971-1972	9.4	11.3	6.2	5.0	5.6	8.1	3.3
1972-1973	11.7	19.2	11.9	6.8	4.7	8.4	6.2
1973-1974	14.3	21.2	16.0	7.2	2.6	6.5	11.0
1974-1975	10.2	7.1	10.2	4.1	3.4	6.9	9.1
1970-1975	63.0	82.4	59.8	27.3	22.8	39.0	38.6

SOURCE: As in previous tables.

NOTE: 1970-1975 percent changes are not the sums of annual percent changes, since the compounding of annual changes produces the five-year result.

CHAPTER IV DOWNPAYMENTS

Another key element in homeownership affordability is the ability of potential homebuyers to make necessary downpayments. Families able to meet monthly payments may nonetheless not have accumulated sufficient assets to meet downpayment requirements. Downpayments on conventional mortgages (those not FHA-insured or VA-guaranteed) have averaged around 25 percent of purchase price during the 1970-1975 period for both new and existing housing, the percentage rising slightly over the five years.

Median house prices have risen faster than income (see Table 10); therefore, downpayments have risen relative to income. The typical downpayment (assumed to be 25 percent of purchase price) has risen from the equivalent of 58.4 percent of yearly median family income to 64.4 percent for median existing houses, from 59.3 percent to 71.6 percent for median newly-built homes, and from 73.2 percent to 78.2 percent for the 1967 average-quality new house.

The effects of such changes, which are quite moderate for existing and fixed-quality new houses and substantially larger for median new, depend again on the category of homeowner in question.

In general, first-time homebuyers are the families that actually face the growth in downpayment relative to income that Table 10 shows. Assuming they have little investment in other assets that might appreciate with general inflation, they are confronted by a need to save a larger portion of their annual income in order to accumulate downpayments, or to wait longer. Indeed, a median-income potential buyer family would have had to save about 6 percent of gross income during 1975 simply to avoid moving further from its downpayment goal. Increased saving during the 1970-1975 period would have required some reduction in real consumption (other than housing for such a family) since real median income remained essentially constant.

TABLE 10. HOUSE PRICES, DOWNPAYMENTS, AND RELATION OF DOWNPAYMENTS TO MEDIAN INCOME, 1970-1975

	House Prices			Downpayments			Downpayment as a Percent of Median Income		
	Existing	New (Median)	New (Corrected for quality changes to 1967 average quality)	Existing	New (Median)	New (Corrected for quality changes to 1967 average quality)	Existing	New (Median)	New (Corrected for quality changes to 1967 average quality)
1970	$23,000	$23,400	$28,900	$5,751	$5,850	$7,228	[illegible]	[illegible]	[illegible]
1971	24,810	25,200	30,300	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1972	26,710	27,600	32,300	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1973	28,920	32,500	35,600	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1974	32,040	35,900	38,900	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1975	35,330	39,300	42,900	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Change 1970-1975	53.6%	67.9%	48.4%	53.6%	67.9%	48.4%			

SOURCE: CBO calculations based on purchase price data as in Tables [illegible] and [illegible].

Families already owning a home, however, should not experience difficulty in making downpayments when they move--provided that their present homes are sharing in the general increase in house prices. Increase in value of their present houses provides essentially dollar-for-dollar increase in their equity upon sale. At the same time, an increase in price in the homes they intend to purchase probably involves no more than a twenty-five cent increase in downpayment for each dollar (assuming 25 percent downpayments). Thus, for example, if both houses started at the same 1970 value, a family's present house need increase in value by only 25 percent of the increase in that of the desired house (existing house prices increased 53.6 percent 1970-1975) in order to leave an adequate equity for downpayment. Any faster rate could provide downpayment for a more valuable next home.

Non-movers are of course unaffected by downpayment problems, and they benefit in the same way as second-time buyers if they move in the future.

FHA-insured loans do provide mortgage financing with much lower downpayment requirements than conventional financing. Current downpayment requirements in the basic, unsubsidized FHA single-family insurance program 203(b) are only 3 percent for houses valued at $25,000 or less, plus 10 percent of value in excess of $25,000 and 20 percent of value in excess of $35,000. Thus the median-priced existing house sold in 1975 would have required a downpayment of only $1,816 and the median-priced new house in 1975 a downpayment of $2,610 under FHA financing. 1/ These are only 13.2 percent and 19.0 percent of median yearly income, far easier to accumulate than the conventional financing figures. But use of FHA insurance has dropped substantially in recent years for a variety of reasons, including ceilings on mortgage amounts, application processing delays, and

---

1/ These are just slightly lower, as a percentage of purchase price, than actual average FHA experience in the past.

restrictions on maximum interest to levels below prevailing market rates. The interest restrictions result in lenders demanding "points"--which are essentially prepaid interest enough to compensate for the lower rate--in order to make FHA loans. If the loan is made at all, these points are generally paid by the buyer 2/ since the seller would otherwise prefer sale to a conventionally financed customer. The result is in effect an additional downpayment.

2/ FHA regulations prohibit payment of points by buyers, but they are in fact in general passed on through higher prices to FHA-financed buyers.

CHAPTER V COMPONENTS OF HOUSE PRICE INCREASE

To understand what might be done to slow the growth of homeownership costs, it is useful to examine increases in individual cost components. The analysis here will focus on the costs of buying and operating a new home from the point of view of first-time buyers, both because that allows looking at the full array of components and because new home costs are an important determinant of costs of existing homes. Of course, people who already own homes (repurchasers and non-movers) face increases in only some of the cost components, and for them various contributors to cost growth will have far different weighting. But, since such families on average have not suffered increases in costs relative to incomes, the components analysis is better directed toward the first-time buyer.

Tables 11a and 11b present the five-year levels of and changes in the first layer of cost components for median-price new houses and for 1967 average-quality new houses respectively. Results are similar for the two house groups. Mortgage interest rates increased very little over the period, even if the calculations were for 1971-1975 (instead of 1970-1975) to avoid the 1970 cyclical peak in interest rates. Sales prices increased far more rapidly, but less than the rate for each of the elements of operating expenses.

What are the components' proportional contributions to the total cost increase over the period? Components that account for a large portion of total initial cost can account for major shares of cost increase, even though they increase at less rapid rates than other items. This is particularly true of sales price and mortgage interest.

For the period 1970-1975, sales price increases are by far the largest contributor to total cost increase, accounting for over 50 percent for median- and fixed-quality houses. Property taxes and heating utilities were the next largest contributors, at about 15 percent and 11 to 14 percent respectively (see Tables 12a and 12b).

TABLE 11a. CHANGES IN COMPONENTS OF OVERALL HOMEOWNERSHIP COSTS, MEDIAN-PRICE NEW HOMES, 1970-1975

	Total Monthly Cost	Monthly Mortgage Payment	Mortgage Payment as a Percent of Total Housing Cost	Sales Price	Interest Rate	Insurance	Property Taxes	Maintenance and Repairs	Heat and Utilities
1970	$217	$141	65%	$23,400	8.45%	$5.65	$31.76	$12.15	$26.74
1971	230	143	62	25,200	7.74	10.09	37.89	13.20	26.27
1972	256	154	60	27,600	7.60	6.50	47.45	15.88	31.87
1973	305	187	61	32,500	7.95	7.84	50.63	20.82	38.54
1974	370	224	61	35,900	8.92	13.12	62.80	24.00	45.35
1975	396	248	63	39,300	9.01	10.68	64.98	26.45	46.21
Change 1970-1975	82.4%	75.9%		67.9%	6.6%	89.0%	104.6%	117.7%	72.8%

SOURCE: See Table 4.

TABLE 11b. CHANGES IN COMPONENTS OF OVERALL HOMEOWNERSHIP COSTS, FIXED-QUALITY NEW HOMES, 1970-1975

	Total Monthly Cost	Monthly Mortgage Payment	Mortgage Payment as a Percent of Total Housing Cost	Sales Price	Interest Rate	Insurance	Property Taxes	Maintenance and Repairs	Heat and Utilities
1970	$268	$173	64.6%	$28,900	8.45%	$6.90	$43.25	$14.89	$30.05
1971	282	172	61.0	30,300	7.74	13.06	50.25	15.86	31.41
1972	299	180	60.2	32,200	7.60	7.79	56.42	18.64	36.28
1973	335	205	61.2	35,600	7.95	12.03	52.62	21.86	43.72
1974	388	243	62.6	38,900	8.92	13.12	62.80	24.00	45.35
1975	428	268	62.6	42,900	9.01	11.43	73.59	29.47	45.23
Change 1970-1975	59.8%	54.9%		48.4%	6.6%	64.2%	70.2%	97.9%	50.5%

SOURCE: CBO computation based on data as in Tables 5a and 5b.

Looking at 1971-1975 (again to avoid peak cyclical interest rates), sales price's contribution is still by far the largest, with mortgage interest now second at about 15 to 17 percent and property taxes close behind. Heating and utilities and maintenance and repair follow.

TABLE 12a. PERCENT CONTRIBUTIONS OF HOMEOWNERSHIP COST COMPONENTS TO TOTAL COST INCREASES, MEDIAN-PRICE NEW HOMES

	Sales Price	Mortgage Interest Rate	Insurance	Property Taxes	Mainten- ance and Repair	Heat and Utilities
1970-1975	55.3	6.2	1.0	15.2	8.1	13.9
1971-1975	47.8	15.1	1.3	14.2	7.8	14.1

SOURCE: CBO computations based on data as in Table 4.

TABLE 12b. PERCENT CONTRIBUTIONS OF HOMEOWNERSHIP COST COMPONENTS TO TOTAL COST INCREASES, FIXED-QUALITY NEW HOMES

	Sales Price	Mortgage Interest Rate	Insurance	Property Taxes	Mainten- ance and Repair	Heat and Utilities
1970-1975	55.2	6.3	1.3	15.3	10.0	11.1
1971-1975	47.9	17.1	-.5	16.0	9.3	9.5

SOURCE: CBO computations based on data as in Tables 5a and 5b.

Because sales price's contribution is so much more significant than the others, it is worth looking at its subcomponents. Unfortunately, there are data deficiencies for some subcomponents. Probably the best breakdown is that of the National Association of Homebuilders for 1970-1974 (updating has been discontinued because of data problems, particularly for land and profit-and-overhead). The data are provided in Tables 13a and 13b.

TABLE 13a. CHANGES IN SHARE OF MAJOR COST ITEMS FOR A TYPICAL SINGLE-FAMILY HOUSE

	Fourth Quarter 1970		Fourth Quarter 1974		
	Cost	Percent Distribution	Cost	Percent Distribution	Percent Change 1970-1974
1. Hard Cost*	$13,188	54.3	$18,040	48.4	36.8
Labor	(4,198)	(17.3)	(5,820)	(15.6)	(38.6)
Material	(8,990)	(37.0)	(12,220)	(32.8)	(35.9)
2. Land	4,925	20.2	7,958	21.3	61.6
3. Financing	1,580	6.5	3,917	10.5	147.9
4. Overhead & Profit	2,940	12.1	4,513	12.1	53.5
5. Other Cost	1,667	6.9	2,872	7.7	72.3
Sales Price	$24,300	100.0	$37,300	100.0	53.5

*See Table 13b for hard cost breakdown.

SOURCE:

Line 1: Hard cost derived from major cost items in NAHB's Construction Components Cost Data in fourth quarter 1970 and fourth quarter 1974. These hard costs reflect a tract-built home of the type associated with FHA/VA construction. Hard cost data were adjusted to the median price of all homes sold as published by the Bureau of the Census, U.S. Department of Commerce, in New One-Family Homes Sold and For Sale, Series C-25. The Census Bureau's fourth quarter 1970 median sales price was adjusted upward to be in line with hard cost data for that period. Detailed hard cost data are included in Table 12b. Labor and Materials based on a study from the Bureau of Labor Statistics, U.S. Department of Labor, entitled Labor and Material Requirements for Construction of Private Single-Family Houses, 1972, Bulletin 1755.

Line 2: Land cost is based on Census Bureau data published in Series C-25. However, fourth quarter 1974 land cost was adjusted upward by using FHA 203(b) cost per square foot data from the Division of Research and Statistics, Housing Production and Mortgage Credit-FHA, U.S. Department of Housing and Urban Development, FHA Trends of Home Mortgage Characteristics; data from NAHB's Builders Economic Council Surveys; and unpublished land cost data from the NAHB Home Owners Warranty Program.

Line 3: Financing cost was based on the prevailing cost of financing at given periods, and reflects the higher cost of construction money rather than the cost of end mortgages.

Line 4: Overhead and profit were derived from what FHA typically allows in individual cities, and from Horwarth and Horwarth, Builders Second Cost of Doing Business (NAHB, 1975).

Line 5: Other cost includes the cost of marketing, servicing, and other incidental and indirect costs.

TABLE 13b. HARD COST AVERAGE CONSTRUCTION COSTS FOR SINGLE-FAMILY DETACHED HOUSING AND PERCENT DISTRIBUTION

	Fourth Quarter 1970		Fourth Quarter 1974		
	Cost	Percent Distri-bution	Cost	Percent Distri-bution	Percent Change 1970-1974
Excavation	$ 185.84	1.4	$ 248.43	1.4	33.7
Masonry	596.47	4.5	1,157.68	6.4	94.1
Concrete	911.80	6.9	1,446.35	8.0	58.6
Lumber	2,035.59	15.4	3,056.00	16.9	50.1
Hardwood Flooring	495.80	3.8	753.06	4.2	51.9
Millwork	1,381.29	10.5	1,838.26	10.2	33.1
Carpentry Labor	1,406.75	10.7	1,837.05	10.2	30.1
Roofing	414.31	3.1	456.45	2.5	10.2
Gutters	136.98	1.0	127.20	.7	-7.1
Lath, Plaster & Drywall	969.28	7.3	1,055.02	5.9	8.8
Tilework	259.42	2.0	313.60	1.7	20.9
Floor Covering	535.16	4.1	605.14	3.4	13.1
Electric Wiring	415.99	3.2	658.13	3.7	58.2
Lighting Fixtures	86.42	.7	167.72	.9	94.1
Plumbing	1,281.45	9.7	1,558.96	8.7	21.7
Heating	652.20	4.9	870.69	4.8	33.5
Painting	662.29	5.0	743.37	4.1	12.2
Insulation	202.38	1.5	285.05	1.6	40.8
Hardware	121.69	.9	252.53	1.4	107.5
Appliances	204.30	1.5	241.61	1.3	18.3
Incidental Cost	233.35	1.8	367.80	2.0	57.6
Total Cost	$13,188.75	100.0	$18,040.10	100.0	36.8

SOURCE: National Association of Home Builders, Construction Components Cost Data.

The largest subcomponents are material, land, and labor in that order. All rose in cost faster than median income or the Consumer Price Index in that four-year period. However, none of these individually has a very great effect on housing costs. Suppose, for example, that land prices held steady for the whole 1970-1974 period. A mortgage for a first-time buyer of a new home would have been reduced by only $240 a year out of $4,415. Thus, the proportion of decrease is only 5.4 percent for a complete elimination of increases in land cost for four years.

The comparable effect of holding all labor costs fixed is about half as large. And the effect of fixing lumber costs--lumber being the largest single component of hard cost and of materials--at 1975 levels is only about one-third as large. The second largest single impact is actually from construction financing costs, which have moderated since 1974. The problem then is the inflation of all the separate costs, rather than the unique escalation of one or a few costs.

CHAPTER VI THE POTENTIAL OF FEDERAL ACTION TO IMPROVE AFFORDABILITY

AFFORDABILITY STANDARDS

It is necessary for discussion to define a homeownership-affordability standard toward which federal action might be directed, but any such standard should be viewed with caution. An often used rule of thumb has been that housing should cost 25 percent of current annual income (for homeowners and renters), but such a single standard has many shortcomings. For example, the remaining 75 percent of income clearly provides for very different levels of material well-being for people of different income levels. Furthermore, individuals make quite different incomes at different stages in life, and they may well expect to (and do) pay higher percentages for housing during their first years as independent households and again in retirement years.

For discussion purposes here, we have selected a nearly equally arbitrary standard: the ratio of (a) cost paid by the median first-time buyer for the median house sold in 1970 to (b) median 1970 family income. This figure was just under 27 percent for both new and existing homes. 1/ The prime reason for the choice is that this paper's analysis is directed toward the perceived problem of decline in homeownership affordability during the first five years of the 1970s. The problem, when defined as change in affordability for the worse, has been found to be confined primarily to first-time buyers (plus those lagging behind the general population in

---

1/ The typical buyer of the median-priced house may have income greater than the median. Still, our standard is close to the traditional rule of thumb. Probably more important, it serves largely as a base from which to consider change, rather than as an affordability "cut-off," so that it provides a useful approximation for non-median income and housing price cases in which rates of change have been similar to that of the medians.

income growth or increase in home value). And the concern for losses in recent years suggests using 1970 as an initial base. We shall consider the mechanisms and costs of returning homebuyer families to that 1970 standard.

As a result of cost increases exceeding income growth, potential first-time purchasers of median income have seen the share of their income required to buy and operate the median existing house rise from 26.85 percent to 31.45 percent from 1970 to 1975. The comparable rise for median new homes is from 26.39 percent to 34.63 percent. These increases are substantial enough to make the difference in some cases between home affordability and non-affordability, though there is a wide distribution of house prices below the median (particularly for existing houses) that may well still be in range. The distribution question is extremely difficult to address because of geographical differences in both prices and incomes.

For second-time purchasers (originally purchasing in 1970), the annual cost-income ratio declined from 26.85 percent to 24.58 percent, and for non-movers (also originally purchasing in 1970) the decline was to 23.70 percent.

The affordability problem for people with lower than median incomes is more acute. A family in the 40th percentile of incomes (about $11,465 in 1975) already needed about 30 percent of income for housing to be a first-time purchaser of the median existing house 2/

2/ As indicated previously, it is extremely difficult to know what price of house to compare to incomes of lower-income people. Public policy certainly might be to encourage and assist lower-income people to purchase a house at less than the median price. A key question is whether houses much cheaper than that (and still in satisfactory condition) are available in the geographical areas in which particular sets of lower-income people live. Clearly in some cases the answer will be yes (and indeed for some of these our definition of lower-income families will fail for lack of

in 1970, and this rose to 38 percent in 1975. The 1975 figure could be reduced to the same 31.5 percent experienced by the median-income family if a 25 percent cheaper (than the median) house could be found. For a family in the 20th percentile of incomes (about $6,914 in 1975), the 1970 percentage was 50 percent and the 1975 percentage 62 percent. For both these lower-income groups, homeownership affordability was already a problem at the start of the decade. At least for the 20th percentile group, the deterioration since 1970 is largely irrelevant because first-time homeownership was already substantially ruled out.

IMPORTANT POLICY CRITERIA

In order to judge the usefulness of policy alternatives in dealing with housing affordability problems, the following criteria can be used:

- What types of homeowners/homebuyers are assisted (first-time purchasers, repurchasers, non-movers)?
- Is the alternative likely to have substantial impact on housing costs?
- Is the impact sustainable?
- What is the income distribution of the people helped by the program?

---

adjustment to local price differentials), and in other cases a comparison of incomes against lower house prices will imply major relocation. In areas where local controls permit, manufactured homes ("mobile" homes) offer a substantially less costly alternative form of ownership. But these homes tend to last shorter periods and depreciate in value over time (at least until recently), so that the kind of alternative they offer is quite different.

- What are the budget impacts for the federal government? 3/
- How is housing construction activity affected by the alternative?

The criteria are selected to reflect both continuing public concerns and the foregoing analysis of affordability.

POLICY OPTIONS

The federal government seems to have a fairly limited number of types of options in attempting to improve homeownership affordability. These include:

- Changes in macroeconomic policy
- Actions to limit increases in specific components of housing costs
- Homeownership subsidies
- Alternative forms of mortgage instruments

3/ Budget impacts are presented below primarily in terms of costs per housing unit. Aggregate budget costs are difficult to specify for several reasons. In many cases, data are not available on the number of eligible potential participants for a given program. Second, there is usually no basis on which to estimate the share of eligibles who would participate in a given subsidy program. Third, and most important, the programs generally envisioned are not entitlement programs, so that Congress controls aggregate costs, by itself choosing the number of families it wishes to assist based on unit costs and other considerations.

The Congress does, however, have wide latitude in choosing budget levels for homeownership support. Obviously the great variety of macro policies have very different budget impacts (and probably very different impacts on affordability). Homeownership subsidies and other housing-specific assistance are generally not in the form of entitlement programs, so that the Congress can choose any desired funding levels directly based on costs per family and other considerations. The following sections attempt to assist decisions about type of homeownership policies and level of funding, by examining options in terms of the above criteria (including per unit costs where possible).

Changes in Macroeconomic Policy

Clearly, one highly desirable option would be to improve the rate of growth of money incomes relative to prices generally--which almost certainly would slow the rate of price increases of homeownership cost components relative to income. This could be accomplished through any combination of increased income growth and decreased inflation, both obviously desirable on many other grounds. The cost component analysis in Chapter V reveals growth in sales price is the chief source of overall homeownership cost increase, but that no single subcomponent is important enough the give much price relief by concentrated effort to slow its cost rise alone. In addition, federal policies probably have very limited impact on land prices, wage rates, or most materials prices. The macroeconomic approach seems therefore particularly important, with action on particular subcomponents taken to try to limit their cost increases to that of the general price level.

Success in raising income growth relative to inflation would assist all three major categories of homeowners. It could certainly have substantial impact on housing costs in relation to income. To the extent that the successful macro policy is itself sustainable, the favorable effect on homeownership would certainly be sustained. People at all income levels would be aided, and policies which decreased unemployment would be particularly beneficial to low-income people's ability to

88-114 O - 77 - 25

own homes. Budget impacts are heavily dependent on the macroeconomic strategy pursued. If decreased inflation is a part of the macro effects, housing construction activity should be spurred both by improved affordability and perhaps by lower interest rates.

Actions Directed Toward Housing Cost Subcomponents

Although interest rates have climbed relatively slowly in the last five years, interest still is a major cost element of homeownership. In addition, the federal government has substantial impact on mortgage market interest rates through monetary policy, regulation of lenders, and the activities of government and government-sponsored lending and mortgage-supporting agencies. These last include FHA and VA as mortgage insurers; HUD and Farmers Home Administration as direct lenders; and GNMA, FNMA, and FHLMC as purchasers of mortgages from original lenders. 4/

Thus actions to lower mortgage interest rates present themselves as an attractive set of federal policies to improve homeownership affordability, for both first-time buyers and repurchasers. However, the interest rate reductions required to return median-income families even to their 1970 ability to afford the median house (as first-time purchasers) are quite substantial. A one percent reduction in mortgage interest rates would have reduced 1975 monthly housing costs for the median existing house by $18 from $360 to $342. Market interest rates for mortgages on existing homes would have to fall from over 9 percent presently to about 6.25 percent in order to give such families 1970 affordability. Such interest rates have not prevailed since 1967. For median new homes, the required reduction would be from 9 percent at present

4/ For a detailed description of these agencies' activities, see CBO Staff Working Paper, Housing Finance: Federal Programs and Issues, September 1976.

to just over 3.9 percent, lower than any time during the last 20 years. 5/ Mortgage interest rates required to bring homeownership into reach of lower-income households are significantly lower still, so that general lowering of rates would mainly benefit middle- and upper-income households.

Substantial reduction of market mortgage interest rates is not a simple matter. The monetary policies that might be used to attempt the reduction could fuel new inflation, aggravating the rise in other homeownership costs and impeding the fall in interest rates. In addition, if the rate of growth of other costs continued to exceed income growth, ever lower and more unrealistic interest rates would be required to hold affordability steady. A more promising approach would be to aim for modest decreases in mortgage interest rates along with greater growth in income relative to prices. The budget impacts of such an approach again vary widely with the particulars of actions undertaken. Lower mortgage interest rates should contribute substantially to new construction.

As indicated in the discussion of macroeconomic alternatives, the potential impact of slowing increases in cost subcomponents other than interest is quite limited, both because no subcomponent is a very substantial share of housing costs and because federal control over such costs is quite limited. Policy levers (actual and potential) are largely regulatory (forest-cutting limitations, wage guidelines including Davis-Bacon requirements, fuel price controls), and the ability to use them is further constrained by market forces and non-cost considerations.

5/ Some of the policies that would lower mortgage interest rates would also serve to reduce the cost of shorter-term construction financing, thereby lowering the sale price of new housing and perhaps indirectly of existing housing. To the extent that that occurs, the required mortgage interest reductions would be smaller.

Which group of homeowners would be aided is, of course, dependent on which price subcomponents receive emphasis, but no one would benefit greatly unless action were taken on many of the subcomponents simultaneously. While a full discussion of actions to reduce subcomponent cost increases is beyond the scope of this paper, it seems most likely that actions can most reasonably be directed toward limiting subcomponent increases to near the general inflation rate while concentrating on reducing overall inflation.

Homeownership Subsidies

A further federal alternative already employed is subsidizing of home purchase. This has proceeded largely through subsidization of interest rates--either annually through payment of part of a buyer's mortgage payment (e.g., Section 235), or in one lump sum by agreeing to buy below-market loans at above-market prices from private lenders who agree to make them, and then reselling them at a loss (GNMA "Tandem" programs). 6/ The fact that

6/ Of course the largest federal homeownership subsidy by far arises through the income tax deduction for mortgage interest and property taxes (about $8.2 billion in 1976). This tax expenditure is not given extensive treatment here, largely because major changes in it are not under immediate active consideration. Suggestions to limit the maximum size of the deduction, to restrict it to one home per taxpayer, or to convert it to a tax credit would reduce benefits to the wealthy. But such plans would have little impact on the homeowners discussed in this paper. A suggestion under longer-term consideration, but with a politically cloudy future, is to eliminate the deduction. A median-income family of four buying a median house in 1975 would have suffered an increased tax burden of about $580 had the deduction not existed.

these are viewed as interest subsidies is really incidental, except sometimes as a means of determining subsidy amount. Subsidy payments in the same amounts could be made to the buyers and called general homeownership grants or some other name.

Subsidy amounts required to restore 1970 affordability (again for first-time buyers) are quite substantial. At the end of 1975, the annual subsidy cost for a median-income purchaser of the median existing house would have been about $635. The one-shot "tandem" loss would have been about $5,090. 7/ For a purchaser of the median new house, annual subsidy cost would have been almost double at $1,126 with "tandem" cost of about $9,650. And, of course, the costs would have to increase further to compensate for future declines in incomes relative to housing costs if those were to occur.

It is highly notable that current Section 235 and recent "tandem" programs were not to be used for existing houses (except substantially rehabilitated houses under Section 235). This increases their value as contributors to housing construction activity and macroeconomic goals. 8/ But it greatly increases the costs of using such programs to improve homeownership affordability, because of the higher noninterest costs of newly built homes. Actual unit cost of Section 235 was $850 per year and of GNMA Tandem $1,819 (one-time cost) in 1976.

It is also important to note that the current programs are in no way restricted to first-time purchasers.

7/ Assuming 25-year mortgage with expected actual life of 12 years, 75 percent of sale price.

8/ Programs subsidizing purchase of existing homes could encourage construction of new homes by improving the resale market for homeowners who wish to sell their present home and move to a newly constructed one. But this construction impact would probably be small compared to the effect of providing subsidies for new-home purchase only.

Absence of such a restriction also helps meet macro-economic goals. But since our analysis shows that people already owning homes have not been losing ground in the 1970s, at least in general, subsidy programs designed in the future specifically to deal with affordability problems might well be targeted to first-time purchasers.

A third important note is that households with lower than median incomes require much deeper subsidies. A family at the 40th percentile of incomes in 1975 could afford (with 26.85 percent of income) to buy the median existing house only with a $1,235 annual subsidy (equivalent to a 3 percent interest rate). 9/ A family at the 20th percentile could afford that house only with a $2,450 annual subsidy, which in a "interest subsidy" program would imply a rate substantially less than zero. The current Section 235 program is really only reachable by families just below median income (i.e., 90-95 percent of median income) if at all, in most places (based on house prices actually experienced and required family contributions); and the Tandem programs, involving interest rates at seven and one-half percent and up, are even less accessible to low- and moderate-income people. Thus funds spent on modest homeownership affordability subsidies are very unlikely to go to low and moderate income people. 10/

9/ More current calculations are precluded by lack of data on family incomes during 1976.

10/ See CBO paper, Housing Assistance for Low- and Moderate-Income Families, (January 1977) for an extended discussion of alternative means of assisting low-income people.

Alternative subsidy programs could be targeted differently from Section 235 and GNMA Tandem programs. Without requiring basic changes in program form, the subsidies could be restricted to purchasers of existing rather than new homes, and/or to first-time homebuyers, and/or to people of lower incomes (of course involving higher per unit costs). Such restrictions might more directly address the issue of homeownership affordability, although with costs in terms of such other objectives as construction stimulus and mobility.

Alternative Mortgage Instruments

A final major alternative to improve affordability is the use of various graduated payment or deferred payment mortgages. The former provides lower monthly payments in early years and higher payments in later years of mortgages, contrasted to the level-payment mortgage now in common use. This pattern allows the homebuyer family to take advantage of the fact that inflation will tend to increase its income over time (particularly for the young, first-time purchaser) while mortgage principal and interest rate will be fixed. While there are disadvantages in slow initial build-up of equity and some risk of future incomes falling short of expectations, the plan has the powerful advantage of improving affordability for the key first-time purchaser group without involving direct federal expenditures. (Some tax expenditures would be involved because of larger interest costs that slower equity build-up would create, and government insurance of the mortgages could result in outlays later.) Various forms of such mortgages have been proposed, with legislation required if the loans are to be federally insured (e.g., Senator Brooke's proposed S. 3692), and permission from regulatory agencies required for lenders to make some types of loans. The Ford Administration proposed a plan to provide insurance for a limited number of such mortgages under Section 245 of the National Housing Act.

Graduated payment mortgages could be available to buyers of existing as well as new homes, and to first-time buyers as well as others. Targeting may not be important from a federal viewpoint if public costs are minimal, but if the insurance costs prove substantial, it might be desirable to limit availability to first-time

buyers and/or buyers of existing houses, with the latter as always affecting impact on new construction activity. Graduated payment mortgages would be of limited use to lower-income people, since if initial payments were to be lowered enough to enable them to afford homeownership, the rate of increase in payments required to meet their full obligation over the mortgage term might well be higher than reasonable expectations of income growth, except for the most upward mobile.

Deferred payment mortgages involve partial payment of mortgage costs by the federal government in early years, with later repayment with interest. The advantages and disadvantages are quite similar to those of graduated payment mortgages, with the important exception that substantial government outlays are required at the outset. In terms of current budget outlays for such a program, the annual cost per unit to reach any particular affordability standard is initially the same as for an ordinary direct subsidy discussed above. This is because no significant repayments of the government's payments would be made until later years. Thus, for example, the cost of returning a median income, first-time homebuyer's family to its 1970 ability to afford a median price house would again be $635 a year. The long-run net cost of deferred payment mortgages should be zero. Once the government's payments had been in operation for a number of years, annual total outlays should be zero, since repayments on previously made loans should offset federal expenditures on new loans (assuming program size was unchanged). These outlays might again best be targeted to first-time buyers, with the focus on existing housing if affordability rather than construction stimulus is the goal. Low-income people would again not benefit unless the early government contributions were extremely large, and even then might not be able to handle the later payments.

Downpayment affordability can be improved by improving income to price increase ratios (macroeconomic), subsidizing downpayments, or reducing downpayment requirements. The macroeconomic approach is in concept obviously the same for downpayments as for annual costs. The subsidy approach probably should be restricted to

first-time buyers because of the effects of sales price increases on downpayment ability of families who are already homeowners, as explained in Chapter IV. Required downpayments are already very low for FHA-insured loans.

Changes in the FHA program might expand its use and thus provide relatively low downpayments to some homebuyers. The major problem with such an approach is that potential homebuyers with relatively low income, who need aid in meeting downpayment requirements, would be hard pressed to meet the enlarged monthly mortgage payments that low downpayments necessarily produce. For example, for a 30-year loan at an 8.5 percent interest rate, the reduced downpayment on a median 1975 new house results in additional annual payments of $660, an increase of nearly 15 percent in total annual housing outlays over costs with a 25 percent downpayment. Comparable problems apply to VA and Farmers Home Administration programs involving low downpayment loans.

Table 14 summarizes the impacts of major policy types according to the criteria suggested to evaluate measures to improve affordability.

TABLE 14. SUMMARY OF POLICY IMPACTS

Types of Alternatives	Type of Homeowner Assisted	Impact on Housing Costs	Sustainability of Impact
Macroeconomic efforts to increase incomes relative to general price levels	All	Potentially substantial	High
Lowering mortgage interest rates	First-time buyers and repurchasers	Potentially substantial	Difficult to sustain, particularly if trying to offset continued rise in costs relative to incomes
Curbing increases in prices of other housing cost subcomponents	All, depending on which subcomponents	Very limited for any given subcomponent alone	Limited
Subsidies Section 235 GNMA Tandem	Purchasers of new homes, first-time or repurchasers	Modest, because subsidies not too deep	Limited in case of continuing price rise relative to income
Alternative subsidies targeted to first-time buyers and/or existing housing and/or lower-income people	Potentially limited to first-time purchasers and/or existing housing	Depends on subsidy level	Limited in case of continuing price rise relative to income
Graduated and deferred payment mortgages	All but non-movers, but could be limited to first-time buyers and/or existing homes	Moderate, because substantially lowered initial payments require rapid increase	Limited in case of continuing price rise relative to income

a/ Actual annual per unit cost for units reserved in 1976.

b/ Actual one-time cost per unit in 1976.

c/ Estimated first-year cost for program to return median income first-time purchaser of existing housing to 1970 affordability position as of 1975.

TABLE 14. SUMMARY OF POLICY IMPACTS (continued)

Income Distribution of People Assisted	Effect on Housing Construction	Budget Impacts
All income groups, and perhaps particularly lower-income people	Significantly favorable	Depends on mechanisms used
Mainly middle- and upper-, since lower-income people cannot afford to become home-owners without deeper assistance	Significantly favorable	Depends on mechanisms used
All, depending on subcomponent	Limited because of limited cost impact	Depends on mechanisms used
Limited largely to middle- and upper-income	Favorable, but often substitutes for activity which would occur anyway	\$ 850 a/ \$1,819 b/
Potentially including lower- and moderate-income if deeper subsidies	Limited, if directed away from new construction	\$ 635 c/ or \$1,235 d/
Middle- and upper-income, and upwardly mobile moderate-income	Depends on targeting toward or away from new home purchasing	Deferred \$635 e/ Graduated: some tax expenditures and insurance costs

d/ Estimated first-year cost for program to move first-time purchaser at 40th percentile of income distribution to 1970 affordability for median income buyer, as of 1975.

e/ As in footnote c/, but note that in later years subsidies would be repaid.

APPENDIX METHODOLOGY

Methods of analysis are provided below, labeled according to the Chapter of the body of the paper in which they were used.

III FIRST-TIME HOMEBUYERS

Changes in costs for homebuyers were computed as follows. House prices for each year were obtained from National Association of Realtors Existing Home Sale Series (existing houses); Construction Report C-25, Department of Commerce (median price of new houses); Construction Report C-27, Department of Commerce (fixed-quality new houses). (Note that only the last series is limited to houses sold under FHA.)

Mortgages were assumed to be 75 percent of purchase price for all house types in each year (close to averages for conventionally financed houses). No opportunity costs from downpayments were imputed. Separate mortgage interest rates for existing and new homes were obtained from Federal Home Loan Bank Board series for effective conventional rates (including discounts, fees). Mortgage term was fixed at 25 years (again close to actual averages). From these components, mortgage payments were computed.

Operating costs (hazard insurance, property taxes, maintenance and repair, and heating and utilities) were obtained from Specific Characteristics of FHA Section 203 homes sold, using average costs for homes of the corresponding price in each year, available separately for new and existing housing. They were simply added to mortgage payments to obtain total housing costs.

Income patterns against which these were compared were those of all families in the population (or subcategories by income or age). These were not limited to families who actually were first-time buyers in a given year, because the intent was to examine changes in

affordability for all potential and actual buyers. The incomes of actual buyers would provide biased representations.

III BUYERS OF HOMES WHO ARE ALREADY HOMEOWNERS

With one key exception, the data, assumptions, and means of basic housing cost analysis were the same for second-time buyers as for first-time buyers of existing houses. The exception is the assumption that the mortgage principal stays fixed over time for the repurchasers, as a result of the assumptions (a) that the value of their previous house increased its sales price in the same amount as the sales price of their next house, and (b) that that capital gain was (at least could be) applied to the new downpayment.

The analysis of repurchasers' ability to move up to a better house involved simply (a) the computation of total housing cost which a fixed share of their income could pay, and then (b) the trial-and-error discovery of the house price for which that dollar amount covered all housing costs.

Incomes were again of all families (or again subgroups by income, etc.) rather than those of actual repurchasers in a given year.

III HOMEOWNERS WHO DO NOT MOVE DURING THE PERIOD

Rates of cost change for non-movers were based initially on the assumption of the homes being purchased in 1970 (and otherwise using data and assumptions as for first-time homebuyers). The house sale price and interest rate (presumably from more distant past purchase) which would result in income and total housing costs moving at the same rate from 1970 to 1975 were computed by trial and error.

Incomes were again for all families, rather than for non-movers alone.

IV DOWNPAYMENTS

The analysis of downpayments proceeds with the same data and assumptions as in Chapter III--the key being that downpayments are assumed to remain at 25 percent of purchase price.

V COMPONENTS OF HOUSE PRICE INCREASE

Changes in housing cost components are computed from the data and assumptions described for first-time buyers of new housing. Percent contributions are computed according to the following method. Calculate the total dollar increase in housing costs 1970-1975. Calculate the dollar increase from the increase in actual sales price alone in the period and compute what percentage that (plus part of the hazard insurance cost increase corresponding to rising sales price) constitutes of the total increase in costs. That provides sales price contribution. Then compute the further dollar cost increase from the actual rise in interest rates (with sales price at 1975 levels) and compare it to the total cost, providing mortgage interest's contribution. Do the simple calculation for each operating cost.

VI THE POTENTIAL OF FEDERAL ACTION TO IMPROVE AFFORDABILITY

The methodology for computations in this section is an extension of the straightforward approaches already discussed.

GLOSSARY

FHA. Federal Housing Administration.

FHLMC. Federal Home Loan Mortgage Corporation.

FNMA. Federal National Mortgage Association.

GNMA. Government National Mortgage Association.

HUD. Department of Housing and Urban Development.

VA. Veterans Administration.

The CHAIRMAN. Thank you. Senator Brooke has to leave right away, so I will yield to him.

Senator BROOKE. Thank you, Mr. Chairman. Mr. Schechter, I am sure you are well aware of the high respect I have for you. I was really surprised at labor's position on this legislation. I am well aware of your strong position on tax expenditures. I understand the history of it and the reason for it.

I obviously do not agree with you in this particular case. But I can't understand the strong position that you have taken on GPMs. I think you are the only witness that has testified before us, who has taken such a strong position on GPMs. And I think even Mr. Mundel's testimony and his reference to "Home Ownership and The Changing Relationship of Costs and Income and Possible Federal Roles," which is an excellent study which I have referred to quite extensively, points out the need for an alternative mortgage instrument.

In think it states clearly and unequivocably that that high monthly mortgage payments is the primary problem for first-time home buyers.

You make a statement in your paper that the standard mortgage is performing very well. And you seem to have completely overlooked the fact of inflation. Certainly your labor constituency falls within that $15,000 income group that we are trying to help. Both the chairman and I are in agreement on GPM's, and we feel that there is a need for a new mortgage instrument.

In addition, though the primary purpose of the bill is to benefit the first-time home buyer, certainly the secondary purpose was to stimulate housing construction in the country, which I am sure you would agree needs some assistance.

Now I will give you an opportunity to respond to everything that I have said, but my question is: we have heard much testimony again including Mr. Kaplan's, that indicates that GPM's could benefit a significant number of families.

Dr. Shalala maintained that it is not just the upward mobility families who would benefit, but any family who expects their nominal income to grow at the rate of inflation.

Could you say why you are opposed to giving the young buyer the opportunity of choosing this mortgage instrument?

Mr. SCHECHTER. Senator, let me approach this perhaps from a few different considerations.

First: As I pointed out in my testimony, the additional cost to the average worker—I actually used in making this calculation a $15,000 income for the family that you used—the $6,000 would amount to approximately 1 percent of lifetime income.

I think that is a high price to ask people to pay to have this option given to them, when there are other alternatives.

Now I certainly share your concern, sir, for helping people to acquire housing that they need and for seeing that we have more construction.

Senator BROOKE. Doesn't that ignore the inflation and the increasing value of the property?

Mr. SCHECHTER. The increasing cost of the property, I know there has been a lot of talk, and if, and I emphasize the "if," which is the way the Harvard-MIT study used it, if we had an additional increase

in costs over the next 5 years that we had over the last 5 years, by 1981 we would have the $78,000 median home price.

That "if" is very important. It is like saying if we had another period when we had a quadrupling of oil prices, when we had the conjunction of a crop failure and the disappearance of the anchovies from the Peruvian coast.

Senator BROOKE. But you and I have seen it creep up to $48,000.

Mr. SCHECHTER. We have. I don't think though we will have the same conjunction of factors that we had before. I am not saying we are not going to have inflation.

Senator BROOKE. I am not saying we are; I don't know.

Mr. SCHECHTER. But on the other hand, when we go to a graduated payment plan, we are providing for building in inflation, because we are saying the person is going to have to be increasing his housing payments from what he started with.

Therefore he is going to have to have a higher income. Even if it is somebody who otherwise might not have a higher income, he is going to have to fight for a higher income. And therefore we are building in an inflationary problem.

Senator BROOKE. Actually, with that increased cost of the monthly payments to the buyer, there would be an increase in income. That is the theory on which this is based.

Mr. SCHECHTER. Sir, when the total cost over 30 years, and a great many people live in their homes for 30 years as we see from the mortgage-free homes, is $6,000, this is an increased cost as compared to a fixed-payment mortgage.

Senator BROOKE. Do you actually believe the wealthy family would postpone purchase of the first home in order to take advantage of the IHA?

Dr. Rosen told us yesterday that this would not make economic sense for the upper income family, because of appreciation in the value of the home during that 4-year period.

You probably heard the dialog I had with Dr. Woodworth this morning. Do you really think the wealthy family would postpone the purchase?

Mr. SCHECHTER. Not the wealthy family, but as you know, Senator, now we have a lot of single persons forming households and even buying homes. And I can think of some personal instances of young men in their latter 20's who aren't married yet, with good incomes, who could very well adopt this provision.

I don't know if it will be a wholesale sort of thing. But if you wish, Senator, I also referred to the possible cost—I really cited the HUD $6 billion and perhaps that is somewhat high. But if we just look at the thing, even if 1 million home buyers used the maximum amount of IHA deposits——

The CHAIRMAN. I am sorry, I have to interrupt. I have to run, and I will be right back.

Mr. SCHECHTER. Even if 1 million used it, this would mean about $10 billion in exempt income put into savings.

And at 25 percent, $2.5 billion is right there. Well, even $2½ billion I think is a substantial sum, and if perhaps half of those home buyers would have bought homes anyway, I think it is a rather unnecessary expenditure.

88-114 O - 77 - 26

Senator BROOKE [presiding]. Have you compared that with the cost of a shallow subsidy?

Mr. SCHECHTER. Well, when you speak of shallow subsidy, I assume you mean going to people who in a way have passed the means test——

Senator BROOKE. I am not quite sure we would agree on what the means test is.

Mr. SCHECHTER. An income level.

Senator BROOKE. Right. As you know, I have indicated a willingness to place an income limit in this bill.

I haven't said just what it will be, but it would be in the range I think we are talking about.

Go ahead, excuse me.

Mr. SCHECHTER. On the so-called shallow subsidy, something like the tandem plan, certainly it is a one-time proposition, and if the Government absorbs a 10-percent discount, actually it was 8 percent I think toward the latter part of the Brooke-Cranston operation, on a $40,000 home, say it might be $4,000, if the mortgage is $40,000; the price of the home it might be somewhat more.

Senator BROOKE. Mr. Schechter, you point out in your testimony how home ownership expanded from 44 percent of the occupied units in 1940 to 63 percent in 1970.

During this period inflation averaged approximately 2 percent, and the average interest rate was in the range of 5 percent.

In this environment the level payment mortgage worked well to expand home ownership opportunities.

Do you really think that the level payment mortgage can work as well to expand home ownership opportunities in an environment of 6 to 7 percent inflation, which we have today?

Mr. SCHECHTER. Well, let's look at what happened during 1976 and the latter part, particularly. Thanks to the Brooke-Cranston bill, I think, there were 274,000 mortgages purchased in 1975 and 1976 by GNMA at below market interest rates. These were mostly 7½ to 8 percent. At the same time, the market forces happened to be in conjunction, so that in 1976 we got some decline in the market interest rate, perhaps from 9 to 8½.

I think some further improvement of that sort is not impossible. In that environment, in the present environment, with such financing, we had single family home starts at the rate of about 1.4 million, we have new home sales at a record rate of about 800,000 a year—not a record for all time, but a very good record.

I think we could get some additional improvement, and we need it. I think this can be done by some attention to monetary policy, by some of the interest rate subsidies we have. And furthermore, to the extent that we are going to meet other housing needs, I think the need is in the area to which you have given support so well in the past, for the low income rental housing programs.

Senator BROOKE. You are well aware, Mr. Schechter, that there was a delay in home purchases because of the fear of the recession in 1974 and 1975.

Mr. SCHECHTER. I think, Senator, there was a sequence of events. First, before the recession we had 9½ and 10 percent mortgage inter-

est rates, and that is when the starts really began to plummet. The demand fell away. And that brought us into the recession.

So that I think if we can manage to bring down the interest rates, instead of having them go up, we might do better.

Senator BROOKE. There is no question about that. I think that we all favor reduction in interest rates. The question is how.

Mr. SCHECHTER. Well, as I have said many times here before, I believe we have to get to a new method of credit regulation, instead of a single instrument that we have, which is tight money policy, so-called general tight monetary policy.

But we know from repeated demonstrations over the last 25 years that it is not general. It becomes a selective policy which falls primarily on housing, and secondly on State and local government construction, and unless we get to another way of restricting the use of credit, which is more equitable, I am afraid we will continue to have the pattern we have had.

Senator BROOKE. I just want to mention again that what we do is to give the home purchaser an option between the level payment mortgage and the GPM. I think most would agree that what we are trying to do is find a new mortgage instrument, that the level payment mortgage does not take care of some of the problems that are facing us today, such as inflation.

Mr. SCHECHTER. I would certainly like to see a trial. We have an experiment that has just started. It can operate in 19 States, which is not a small area of the country. There is also a good deal of experimentation going on in conventional financing of GPMs. Can't we try to get some experience before we—it won't take too long to run through one cycle—before we embark on something untested?

Senator BROOKE. In your statement, you did recommend a trial experiment through one business cycle. What do you see as the advantage of a trial, especially when you take into account that the experiment is limited to only 1 percent of the mortgages?

It seems to me, as Mr. Smith testified yesterday, since HUD is involved in only 8 to 10 percent of the total mortgage insurance market, a 1 percent sample is not extensive enough to make a complete analysis and provide us with an accurate picture of GPM activity.

Mr. SCHECHTER. I think we might get something like 5,000 loans a year out of that. In addition, there are the ongoing lending GPM programs, particularly in California, by conventional lenders which could be looked at.

Senator BROOKE. I have some more questions that I will submit to you for the record. And thank you, Mr. Schechter. As I said earlier, I would hope that, since I know labor's purposes are the same as those of the chairman and my own, we can work as allies in this effort.

I think you would agree that there is a need to help people purchase that first home.

Mr. SCHECHTER. There is no disagreement on that, sir. It is just a matter of which alternative we use.

Senator BROOKE. Right. Mr. Mundel, you testified that the effect of the GPM on first-time home buyers would be substantial.

Could you estimate how many families who could not otherwise afford a home would become likely home buyers under the GPM program?

Mr. MUNDEL. We have not attempted to do that kind of estimate and I am not sure whether there are enough data on the determinants of first-time purchase to allow a really concrete assessment of the number of people that would be moved into that group.

But I will check on that.

Senator BROOKE. I wish you would give serious consideration to that. Obviously that would be the other side of the question I asked Mr. Schechter.

I would like to know what we are talking about in terms of numbers. And it would be a significant factor in the passage of the legislation.

You indicate in your statement that the IHA would not provide much improvement for low and moderate income first-time home buyers. I would agree that lower income home buyers who cannot afford to save toward a downpayment could obviously not be benefitted. Your chart on page 11 (see page 328), shows there would be a real benefit for families with a gross income of $11,000 to $14,000. The chart on page 6 (see page 323), shows that the greatest percentage of first-time home buyers fall into the $10,000 to $15,000 income category, 29.1 percent.

Now wouldn't this be the group most likely to take advantage of the IHA?

Mr. MUNDEL. Well, I think the one thing we don't know, Senator, is whether or not families with incomes of that range can afford to contribute substantial amounts to individual housing accounts, and therefore take advantage of the tax exclusion on those accounts.

We do not have good enough data on their savings patterns, nor on whether or not if these additional tax incentives were provided, their savings would change.

Senator BROOKE. I want to thank you, Mr. Schechter, and Mr. Mundel, for your excellent testimony, and I also will ask you to continue to work with us and see if we can't find some solution to this very serious problem.

Thank you.

Mr. MUNDEL. We would be happy to do that.

The CHAIRMAN [presiding]. Mr. Schechter, in your statement you talk about the GPM cost of the home buyer over the life of the loan, and you discussed that with Senator Brooke.

That seems to me to be a choice that the home buyer can make. He makes it anyway, instead of taking a 10-year mortgage, or 20-year mortgage, he takes a 30-year mortgage. The longer the mortgage, the more he pays, and he pays a whale of a lot more if it is a longer term. So that fact by itself, it seems to me, should not necessarily make it wrong to give him this choice, as long as he understands what he is doing.

Furthermore, you said there are many people who live in the same house for 30 years. That is true. Millions do. But also the average, most people, don't live in it that long. The average is 8 years. And they therefore will never pay most of that interest.

Mr. SCHECHTER. Well, this raises a question, of course. Would the program permit somebody to purchase a home under the graduated

payment plan, live there the first few years when the payments are lower, the debt increases, and then sell it or try to sell it, leave it with the larger debt, and he has had the benefit of lower payments?

The CHAIRMAN. But of course that depends on what happens to the economy, what happens in the locality. If we have serious inflation, and if the value of the property increases, he is in good shape. He makes that judgment though to begin with if he is informed.

And isn't it analogous to the fact that you do have somewhat the same situation if you take a long-term mortgage. You pay a lot more interest on a 30-year mortgage, and I mean a lot more than $6,000.

Mr. SCHECHTER. But you are not letting yourself in, when you do that, for the higher payments later, whereas in the graduated payment mortgage, the buyer, although he makes that choice, sure; but there is the danger that we will get more and more lenders who might want to "sell" that type of mortgage, especially when money happens to be fluid, in good supply, and during such periods we might get many people, I would say "sucked into" such mortgages.

The CHAIRMAN. Dr. Mundel, you had a very interesting point here. Your statement emphasizes that the people who are having difficulty affording homes today are first-time buyers.

At the same time you say that 50 percent of the home buyers in 1974 were first-time buyers. You show on page 6 (see page 323), that the overwhelming bulk of the first-time buyers are between 18 and 34 years old, the group we call the young family. Am I correct that you deduce from these data that the affordability gap problem is not so much based on youth as it is on deeper economic differences between buyers and nonbuyers?

You say the people who are managing to buy first homes are the young middle-class families, who are succeeding in saving a downpayment, while those who are not buying are the families who are and remain moderate income people.

Mr. MUNDEL. Yes; first-time buyers are predominantly middle income.

The CHAIRMAN. We have stressed this as something that will help people in all levels. I think you emphasize that that may not be quite as much the case as we would like to believe.

Mr. MUNDEL. Yes; I think we are finding that homeownership among young families continues to be quite strong, even under the fixed-payment mortgage terms, and under the current patterns of tax treatment of savings accounts.

The CHAIRMAN. So the moderate income people we all want to help, as Senator Brooke and Mr. Schechter both agreed, the $15,000 family who are on a fairly steady income, probably wouldn't get as much help from this. Is that right?

Mr. MUNDEL. Yes; affordability of housing for those people has declined, but they continue largely to be either homeowners, or if they are young families, to be first-time purchasers of homes. The proportion of families that are homeowners, even during this period of declining affordability, continues to grow.

The CHAIRMAN. Mr. Schechter, would your concern about the higher long-term cost of GPM's be answered if we had something

like the truth in lending requirement on the finance charge, that we require them to show what the finance charge is, and we show the bottomline, 30-year cost, in both cases?

Mr. SCHECHTER. I recommended that that be done in the experimental program.

I might note that just recently the Federal Reserve Board in its truth in lending regulations is requiring that that sort of comparison be shown on the variable interest rate mortgages made by conventional lenders.

The CHAIRMAN. I presume we might have the same requirement here. We could require that in the law.

Mr. SCHECHTER. This happened very recently, and I would hope you would include that.

The CHAIRMAN. We deal with that, so the home buyers know what they are getting into.

Wouldn't that meet a large part of your problem? After all, it simply tells him what the facts are, and if people want to make mistakes, or want to take advantage of a situation, why not let them do it? It is a free country.

Mr. SCHECHTER. It is a free country, sure, but there are alternatives of policy, and we would be encouraging this route to meet housing needs, instead of the route we have been using, which it is almost a redistribution question. The percentage of national income going to net interest payments, that line in the national income accounts called net interest payments, has gone up over the last 40 years from 1 percent to 6 percent. It keeps rising. It rose pretty quickly in the last few years. More of the income flows to those who happen to have funds and large savings, and therefore, can get interest returns.

And this is the route we would be choosing if we go along with the graduated payment. Because all of that extra cost to the home buyer is really extra payments for interest.

Now we can say this is a matter of free choice of the individual. But it is also a matter of what policies we bless, in effect, and enact into legislation, to use as a vehicle to help people obtain homes.

The CHAIRMAN. Mr. Mundel, would I be correct in concluding from your statement that you would prefer an interest-rate subsidy for moderate-income home buyers, and a savings account subsidy for all first-time home buyers?

Mr. MUNDEL. I think it is fair to point out that those are two of the alternatives; one would lower the monthly carrying costs; the other would increase affordability of downpayments. We do not as a policy of CBO make recommendations or state preferences among alternatives. Those are alternatives.

The CHAIRMAN. Mr. Schechter, you are concerned about what will happen to people if they take GPM's and can't afford the increased payments.

Would it help if lenders were required to allow them to refinance without a prepayment penalty?

Mr. SCHECHTER. That would certainly make it more palatable to those people who choose it. But every additional benefit that the lender allows, he is not going to give it away free. As was indicated

here this morning, the insurance premiums will be higher than on a regular mortgage.

Of course, each additional benefit of that sort means a higher payment by the borrower.

The CHAIRMAN. Mr. Mundel, would you like to comment, based on your research, on Dr. Rosen's projection that median home prices will reach $90,000 in 1986?

Mr. MUNDEL. Well, we have done some short range 5-year projections as to the rates of inflation which go out to 1982. I have not checked whether his assumptions in the near term agree with ours. We do not have long-term—to 1986—projections of inflation. I think any of these projections, either projections of inflation, unemployment, or levels of income growth are, of course, highly uncertain.

The CHAIRMAN. Well, that is a polite way of saying it. They are often wrong. It is tough enough to try to estimate the inflation we will have next year, and to estimate it 10 years from now is like estimating the weather.

Mr. MUNDEL. That is one reason we stopped at five, although we are nervous then, too.

The CHAIRMAN. Dr. Schechter, in your statement you say a number of States already have conventional GPM's. How long have these programs been operating and do you feel they might provide a record which we should be examining in considering this bill?

Mr. SCHECHTER. I think particularly in California there have been a number of large lenders that have had these programs going for a year or more.

The CHAIRMAN. GPM's?

Mr. SCHECHTER. Yes.

The CHAIRMAN. I know they have VRM's in a big way.

Mr. SCHECHTER. GPM's also. And I believe that perhaps through the Federal Home Loan Bank Board or some of these lenders might be quite willing to cooperate, that a record could be provided.

But I would urge, Mr. Chairman, that an evaluation not be made until we have gone through a business cycle. In other words, until people really get hurt everything looks good.

The same is true of the VRM's they have been making in California, until such time as they have to start raising the rates. So I think to really test it, we ought to go through one cycle.

The CHAIRMAN. Well, I am not sure how long those programs have been operating. We certainly have been through a pretty rough cycle, the worst recession since the deep depression, over the last 4 or 5 years, 1974 was a honey.

Mr. SCHECHTER. I think if there is any substantial record for that period, it should be looked at, yes. I am doubtful whether there are any that go back that far.

The CHAIRMAN. Very good, gentlemen. I want to thank you very, very much for your excellent testimony, it has helped our record greatly.

The committee stands adjourned.

[Thereupon, at 1:05 p.m., the hearing was concluded.]

[Additional material received for the record follows:]

STATEMENT BY LEON T. KENDALL ON BEHALF OF
MORTGAGE GUARANTY INSURANCE CORPORATION
MILWAUKEE, WISCONSIN
ON S. 664,
THE YOUNG FAMILIES' HOUSING ACT

We are pleased to have an opportunity to express the views of MGIC on the "Young Families' Housing Act", S. 664, introduced by Senator Edward Brooke. This is an exciting piece of legislation. It identifies a need, proposes a workable solution, and most importantly, enlists one of the deepest well-springs of the American character, personal incentive for self-improvement in the solution of an urgent national problem. It puts the challenge up to the specific group most concerned, the young families themselves, and it calls on the free market system to provide maximum support to their efforts.

We refer particularly to Section 3 of S. 664, the tax incentive plan, permitting accumulation toward the down payment on a home in a tax free savings account of up to $10,000 by a first time homebuying family. The Individual Housing Account (IHA) invites a growing number of young Americans to help themselves. These are the sons and daughters of the men and women who used their GI loan

privileges to solve their personal post World War II housing shortage. The program provides an excellent market test of how strong the demand is and how sorely people want it to be met.

Americans typically are people with a dream and that is true of both young and old. By challenging that young household to work for achievement of its homeownership dream and pledging government support to make it easier, we can create habits and values which will serve this nation and those individuals in good stead for years to come.

The IHA account would not only help prospective home-buyers to save systematically for their home purchase, but also provide great stimulus to thrift and capital formation in this nation. The disincentives to saving, flowing from the nation's heavy tax burden, and the present high levels of inflation, can be tempered by the IHA account.

The housing support program is aimed at people rather than at stimulating lenders, builders, developers, or housing market investors. In this age of consumerism such focus deserves significant testing. Also, young families will not necessarily buy new houses. As most of us know, first time car buyers who cannot afford new cars frequently buy older, used cars. The same thing happens in housing. A review of our MGIC mortgage insured borrowers (nearly two-thirds of the borrowers insured by MGIC in 1975 were in the group 33 years old and younger), indicates that in the past three years, 63.8% of the 5% and 10% down loans

made by our lenders were on existing rather than new houses. The average high-ratio (90%) loan in 1975 was a mortgage of $30,164 on a house worth $32,321, to a family with an income of $1,513 per month. Thirty-eight percent of those properties in 1975 were in a city; 56% were suburban and 6% were rural. We submit that a young family with few down payment dollars is more likely to buy an existing home, probably in the city, rather than a new home in the suburbs. We believe that is good for this country. Older neighborhoods are most likely to be revitalized by new families of all ethnic and racial origins, with an equity stake in the property, a desire to make that house a home and a commitment to make that community the kind in which they want to live.

Just as the IRA (Individual Retirement Account) has provided unique incentives for men and women saving for retirement, so too, the IHA (Individual Housing Account) can do the same for another deserving group of our society. The wide publicity it will receive from saving institutions is one major key to success. In both instances, inflation, caused as much by government as any other force, has been responsible for the special problems these young and older households face.

Section 2 of S. 664 we also see as a step in the right direction. MGIC has been an innovator in home lending techniques throughout its corporate life. Through private mortgage insurance, we pioneered and

encouraged first 10% down and 5% down conventional home loans. These loans were the fixed rate, long term contract now standard throughout the mortgage industry. It is now time to adopt legislation and regulations to encourage greater experimentation in the marketplace with other forms of alternative mortgage instruments. We are ready to aid in another pioneering effort and stand ready to open our present policies to encompass a conventional graduated payment mortgage to worthy borrowers. Just as the experimentation with savings accounts in the 1960's with thrift institutions, moving from a single passbook account to a family of certificates and accounts, enabled the thrift industry to attract greater savings funds for housing, so too, new home financing options tailored specifically to particular segments of the population hold great promise in helping to house young families today. We feel the mortgage insurance industry of the nation, given appropriate safeguards, can underwrite such contracts and provide greater service for more American families.

In summary, S. 664 is a forward step enabling the thrift and home financing industry of this nation to respond positively to the challenge placed before it by a new generation of first-time homebuyers. We applaud the use of personal incentives and the unleashing of free market forces offered through the Individual Housing Account. We believe the Individual Housing Account will cause young families to re-order their priorities and

start the process which will enable them more quickly to attain individual homeownership, one of the basic building blocks of the stability of this nation. Authority to permit the making of graduated payment mortgages is also a step in the right direction. We urge that it be extended to conventional loans and pledge our services in underwriting such contracts for worthy borrowers.

Leon T. Kendall, President
Mortgage Guaranty Insurance Corp.

Princeton University WOODROW WILSON SCHOOL
OF PUBLIC AND INTERNATIONAL AFFAIRS
PRINCETON, NEW JERSEY 08540

April 7, 1977

Senator Edward Brooke
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Brooke:

Thank you for the opportunity to testify on the Young Families Housing Act. I hope that we have helped open a few minds to the problems that will be confronting the housing market in the next few years. I have enclosed a copy of my calculation on the probable, not the maximum cost of the IHA. Both HUD and Treasury were using assumptions meant to put the program in the worst possible light. I would suggest that you ask GAO and CBO to provide you with cost estimates for the unrevised and then a revised version of the plan. I think a revision putting an income limit of $20,000 and making the IHA a tax credit of say, $500, would substantially satisfy the objections of the administration. The concept seems to me extremely valuable. Savings for housing plans of some type are used in most industrial countries of the world. I would propose that you ask GAO or CBO again to provide background material on these various plans.

Again, I appreciate the effort you made in behalf of the bill. We may not have won this battle, but as anyone in the housing field can tell you, the problems are indeed real. If HUD bureaucrats would establish some real world contacts, they would realize that it is not a problem of economic theory but the cruel reality of a highly inflationary housing market that we are facing. As will be reported next week by the National Association of Realtors, prices in the western region of the country rose 23.5% in a one year period! The housing price explosion is not a distant fantasy but a reality, and

Senator Edward Brooke April 7, 1977

within 1 or 2 years it will be considered of crisis proportions. HUD unfortunately has no ability to assess this problem.

I hope to see you again soon.

Sincerely,

Kenneth Rosen
Assistant Professor of Economics
and Public Affairs

KR:mcl
encl.

Appendix A

Cost of IHA

The method used below to compute the cost of the IHA relies on actual behaviorial experience from the Canadian RHOSP plan. This data extrapolated to U.S. environment should be far more reliable in terms of estimating participation rates, maximium savings amount, etc., than the HUD-Treasury estimates which rely on unrealistic assumptions concerning probable participation in the IHA program.

The following assumptions were made in translating the Canadian to American participation rates and cost figures. First, the Canadian RHOSP account numbers (for individuals) were converted to a household equivalent figure. It was assumed that 15% of RHOSP accounts were held by individuals and 85% by husband-wife households. This Canadian data was then used to calculate probable U.S. participation rates. The procedure used was to multiply the Canadian figures by a factor of 8, which is the average ratio of Canadian single family housing starts to U.S. single family housing starts for the 1973-1976 period. The multiplier procedure based on starts probably overstates potential U.S. participation as a somewhat higher portion of Americans already own their own homes and so would not be eligible for the program.

In calculating the dollar cost of the program it was also necessary to account for underutilization of the account (that is households savings less than the maximum amount on both an annual basis and over the life of the account). The Canadian data indicates that in the first year households saved on average 86% of the maximum $1,000 allowed under the RHOSP provision.

Estimated Cost of the IHA
Based on Canadian Experience

	Number of Households Setting Up Plan (Based on Canadian Participation Rate)	Number of Households Enrolled in Plan (1)	Aggregate Amount Saved (2)	Estimated Tax Loss (3)
1st Year	1.1 million	1.1 million	2.365 billion	591 million
2nd Year	1.0 million	1.935 million	4.160 billion	1.04 billion
3rd Year	1.0 million	2.729 million	5.867 billion	1.46 billion
4th Year	1.0 million	3.404 million	7.318 billion	1.83 billion
Steady-State		3.404 million	7.318 billion	1.83 billion

(1) Assuming 15% use the plan in year following initial setup, and that 15% additional use the plan in year 2 and 3, and that 55% use the plan after 4 full years of enrollment.

(2) Assuming each household saves 86% of $2500 maximum ($2150).

(3) Assuming average 25% tax bracket of household.

DATE DUE			